International Business

COMPETING IN THE GLOBAL MARKETPLACE



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COMPETING IN THE GLOBAL MARKETPLACE

Charles W. L. Hill

UNIVERSITY OF WASHINGTON

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INTERNATIONAL BUSINESS: COMPETING IN THE GLOBAL MARKETPLACE

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For **June** &
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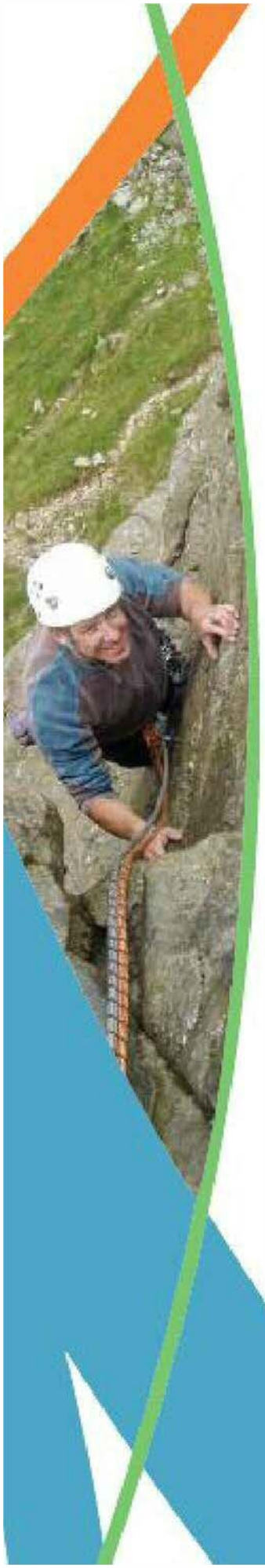

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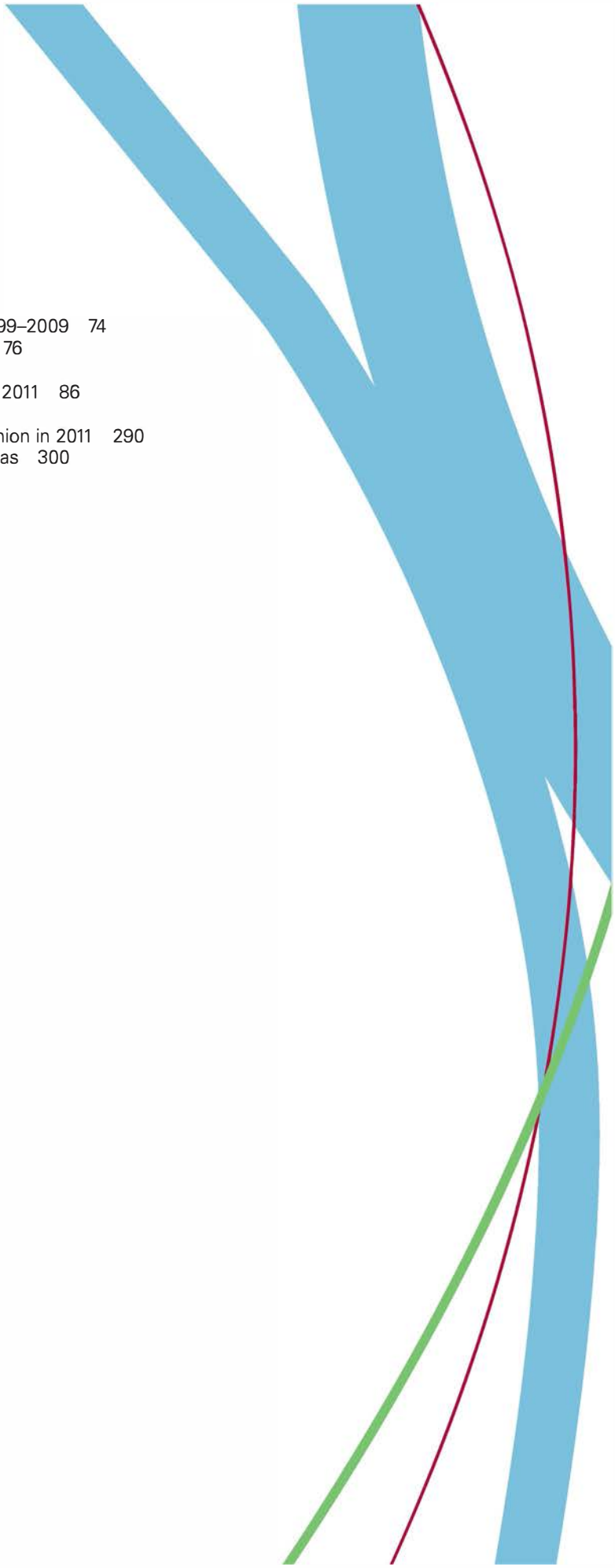

PREFACE

It is now two decades since I began work on the first edition of *International Business: Competing in the Global Marketplace*. By the third edition the book was the most widely used international business text in the world. Since then its market share has only increased. I attribute the success of the book to a number of goals I set for myself when I embarked on the first edition of the book. Specifically, I wanted to write a book that (1) was comprehensive and up-to-date, (2) went beyond an uncritical presentation and shallow explanation of the body of knowledge, (3) maintained a tight, integrated flow between chapters, (4) focused on managerial implications, and (5) made important theories accessible and interesting to students.

Over the years, and through eight additional editions, I have worked hard to adhere to these goals. It has not always been easy. An enormous amount has happened over the past two decades, both in the real world of economics, politics, and business and in the academic world of theory and empirical research. Often I have had to significantly rewrite chapters, scrap old examples, bring in new ones, incorporate new theory and evidence into the book, and phase out older theories that are increasingly less relevant to the modern and dynamic world of international business. That process continues in the current edition. As noted below, there have been significant changes in this edition, and that will no doubt continue to be the case in the future. In deciding what changes to make, I have been guided not only by my own reading, teaching, and research, but also by the invaluable feedback I receive from professors and students around the world who use the book, from reviewers, and from the editorial staff at McGraw- Hill. My thanks go out to all of them.

COMPREHENSIVE AND UP-TO-DATE

To be comprehensive, an international business textbook must:

- Explain how and why the world's countries differ.
- Present a thorough review of the economics and politics of international trade and investment.
- Explain the functions and form of the global monetary system.
- Examine the strategies and structures of international businesses.
- Assess the special roles of an international business's various functions.

I have always endeavored to do all of these things in *International Business*. In my view, many other texts paid insufficient attention to the strategies and structures of international businesses and to the implications of international business for firms' various functions. This omission has been a serious deficiency. Many of the students in these international business courses will soon be working in international businesses, and they will be expected to understand the implications of international business for their organization's strategy, structure, and functions. This book pays close attention to these issues.

Comprehensiveness and relevance also require coverage of the major theories. It has always been my goal to incorporate the insights gleaned from recent academic work into the text. Consistent with this goal, over the last eight editions I have added insights from the following research:

- The new trade theory and strategic trade policy.
- The work of Nobel Prize-winning economist Amartya Sen on economic development.
- The work of Hernando de Soto on the link between property rights and economic development.
- Samuel Huntington's influential thesis on the "clash of civilizations."
- The new growth theory of economic development championed by Paul Romer and Gene Grossman.
- Empirical work by Jeffrey Sachs and others on the relationship between international trade and economic growth.
- Michael Porter's theory of the competitive advantage of nations.
- Robert Reich's work on national competitive advantage.
- The work of Nobel Prize-winner Douglass North and others on national institutional structures and the protection of property rights.
- The market imperfections approach to foreign direct investment that has grown out of Ronald Coase and Oliver Williamson's work on transaction cost economics.
- Christopher Bartlett and Sumantra Ghoshal's research on the transnational corporation.

- The writings of C. K. Prahalad and Gary Hamel on core competencies, global competition, and global strategic alliances.
- Insights for international business strategy that can be derived from the resource-based view of the firm.

In addition to including leading-edge theory, in light of the fast-changing nature of the international business environment, every effort is being made to ensure that the book is as up-to-date as possible when it goes to press. Much has happened in the world since the first edition of this book was published in 1993. The Uruguay Round of GATT negotiations was successfully concluded and the World Trade Organization was established. In 2001 the WTO embarked upon another major round of talks aimed to reduce barriers to trade, the Doha Round. The European Union moved forward with its post-1992 agenda to achieve a closer economic and monetary union, including the establishment of a common currency in January 1999. The North American Free Trade Agreement passed into law. The former Communist states of Eastern Europe and Asia continued on the road to economic and political reform. As they did, the euphoric mood that followed the collapse of communism in 1989 was slowly replaced with a growing sense of realism about the hard path ahead for many of these countries. The global money market continued its meteoric growth. By 2009 more than $2 trillion per day was flowing across national borders. The size of such flows fueled concern about the ability of short-term speculative shifts in global capital markets to destabilize the world economy. The World Wide Web emerged from nowhere to become the backbone of an emerging global network for electronic commerce. The world continued to become more global. Several Asian Pacific economies, including most notably China, continued to grow their economies at a rapid rate. Outsourcing of service functions to places such as China and India emerged as a major issue in developed Western nations. New multinationals continued to emerge from developing nations in addition to the world's established industrial powers. Increasingly, the globalization of the world economy affected a wide range of firms of all sizes, from the very large to the very small.

Also, unfortunately, in the wake of the terrorist attacks on the United States that took place on September 11, 2001, global terrorism and the attendant geopolitical risks emerged as a threat to global economic integration and activity.

Reflecting this rapid pace of change, in this edition of the book I have tried to ensure that all material and statistics are as up-to-date as possible as of 2009. However, being absolutely up-to-date is impossible because change is always with us. What is current today may be outdated tomorrow. Accordingly, I have established a home page for this book on the World Wide Web at www.mhhe.com/hill. From this home page the reader can access regular updates of chapter material and reports on topical developments that are relevant to students of international business. I hope readers find this a useful addition to the support material for this book.

BEYOND UNCRITICAL PRESENTATION AND SHALLOW EXPLANATION

Many issues in international business are complex and thus necessitate considerations of pros and cons. To demonstrate both sides of issues to students, I have adopted a critical approach that presents the arguments for and against economic theories, government policies, business strategies, organizational structures, and so on.

Therefore, I have attempted to explain the complexities of the many theories and phenomena unique to international business so the student might fully comprehend the statements of a theory or the reasons a phenomenon is the way it is. I believe these theories and phenomena are explained in more depth in this book than they are in competing textbooks, the rationale being that a shallow explanation is little better than no explanation. In international business, a little knowledge is indeed a dangerous thing.

INTEGRATED PROGRESSION OF TOPICS

A weakness of many texts is that they lack a tight, integrated flow of topics from chapter to chapter. This book explains to students in Chapter 1 how the book's topics are related to each other. Integration has been achieved by organizing the material so that each chapter builds on the material of the previous ones in a logical fashion.

Part One

Chapter 1 provides an overview of the key issues to be addressed and explains the plan of the book.

Part Two

Chapters 2 and 4 focus on national differences in political economy and culture, and Chapter 5 on ethical issues in international business. Most international business textbooks place this material at a later point, but I believe it is vital to discuss national differences first. After all, many of the central issues in international trade and investment, the global monetary system, international business strategy and structure, and international business operations arise out of national differences in political economy and culture. To fully understand these issues, students must first appreciate the differences in countries and cultures. We discuss ethical issues at this juncture primarily because many ethical dilemmas flow out of national differences in political systems, economic systems, and culture.

Part Three

Chapters 6 through 9 investigate the political economy of international trade and investment. The purpose of this part is to describe and explain the trade and investment environment in which international business occurs.

Part Four

Chapters 10 through 12 describe and explain the global monetary system, laying out in detail the monetary framework in which international business transactions are conducted.

Part Five

In Chapters 13 through 15 attention shifts from the environment to the firm. Here the book examines the strategies and structures that firms adopt to compete effectively in the international business environment.

Part Six

In Chapters 16 through 20 the focus narrows further to investigate business operations. These chapters explain how firms can perform their key functions—manufacturing, marketing, R&D, human resource management, accounting, and finance—to compete and succeed in the international business environment.

Throughout the book, the relationship of new material to topics discussed in earlier chapters is pointed out to the students to reinforce their understanding of how the material comprises an integrated whole.

FOCUS ON MANAGERIAL IMPLICATIONS

I have always believed that it is important to show students how the material covered in the text is relevant to the actual practice of international business. This is explicit in the later chapters of the book, which focus on the practice of international business, but it is not always obvious in the first half of the book, which considers many macroeconomic and political issues, from international trade theory and foreign direct investment flows to the IMF and the influence of inflation rates on foreign exchange quotations. Accordingly, at the end of each chapter in Parts Two, Three, and Four—where the focus is on the environment of international business, as opposed to particular firms—a section titled "Implications for Managers" clearly explains the managerial implications of the material discussed in the chapter. For example, Chapter 6, "International Trade Theory," ends with a detailed discussion of the various trade theories' implications for international business management.

In addition, each chapter begins with a *case* that illustrates the relevance of chapter material for the practice of international business. Chapter 2, "National Differences in Political Economy," for example, opens with a case that profiles the economy of Poland.

I have also added a closing case to each chapter. These cases are also designed to illustrate the relevance of chapter material for the practice of international business. The closing case for Chapter 2, for example, looks at Indonesia's economy.

Another tool that I have used to focus on managerial implications is a Management Focus box. There is at least one Management Focus in each chapter. Like the opening case, the purpose of these boxes is to illustrate the relevance of chapter material for the practice of international business. The Management Focus in Chapter 2, for example, looks at how Starbucks has been able to enforce its trademark in China. This box illustrates the important role that national differences in the protection of intellectual property rights can play in international business.

ACCESSIBLE AND INTERESTING

The international business arena is fascinating and exciting, and I have tried to communicate my enthusiasm for it to the student. Learning is easier and better if the subject matter is communicated in an interesting, informative, and accessible manner. One technique I have used to achieve this is weaving interesting anecdotes into the narrative of the text—stories that illustrate theory. The opening cases and focus boxes are also used to make the theory being discussed in the text both accessible and interesting.

Each chapter has two kinds of focus boxes—a Management Focus box (described above) and a *Country Focus* box. Country Focus boxes provide background on the political, economic, social, or cultural aspects of countries grappling with an international business issue.

In Chapter 2, for example, one Country Focus box discusses how the economy of Venezuela has performed under the leadership of Hugo Chavez.

WHAT'S NEW IN THE 9TH EDITION

The success of the first eight editions of *International Business* was based in part upon the incorporation of leading-edge research into the text, the use of the up-to-date examples and statistics to illustrate global trends and enterprise strategy, and the discussion of current events within the context of the appropriate theory. Building on these strengths, my goals for this revision have been threefold:

1. To incorporate new insights from recent scholarly research wherever appropriate.
2. To make sure the content of the text covers all appropriate issues.
3. To make sure the text is as up-to-date as possible with regard to current events, statistics, and examples.

As part of the overall revision process, changes have been made to every chapter in the book. All statistics have been updated to incorporate the most recently available data. New examples, cases, and boxes have been added and older examples updated to reflect new developments. Almost all of the chapter opening and closing cases are new to this edition. New material has been inserted wherever appropriate to reflect recent academic work or important current events.

Most notably for this edition, *detailed discussion of the global financial crisis that occurred in 2008 and 2009, and its implications for international business, has been added to many chapters*. For example, Chapter 7 opens with a case that discusses the impact of the global financial crisis on attitudes toward protectionism in many countries. Similarly, Chapter 11 closes with a case that profiles how the global financial crisis triggered economic turmoil and a currency crisis in Latvia.

Elsewhere, Chapter 7 has been updated to discuss progress on the current round of talks sponsored by the WTO aimed at reducing barriers to trade, particularly in agriculture (the Doha Round). Chapter 8 now discusses the slump in foreign direct investment flows that took place in 2008 and 2009, and explains how the global financial crisis of 2008 contributed to it. Chapter 10 discusses the weakness in the U.S. dollar between 2004 and 2008, and its paradoxical rebound in late 2008 in the midst of a severe financial crisis in the United States and elsewhere. And so on.

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Guided Tour

Cases, focus boxes, and exercises throughout the book make theories accessible and interesting and show how theory relates to the practice of international business.



part two Country Differences

2

National Differences in Political Economy

LEARNING OBJECTIVES:

After reading this chapter you will be able to:

LO1 Understand how the political systems of countries differ.

LO2 Understand how the economic systems of countries differ.

LO3 Understand how the legal systems of countries differ.

LO4 Explain the implications for management practice of national differences in political economy.

The Polish Surprise

As the financial crisis of 2008 and 2009 unfolded, countries across Europe were hit hard. A notable exception was Poland, whose economy grew by 1.5 percent during 2009, while every other economy in the European Union contracted. How did Poland achieve this? The country benefited from sound economic policy, a stable political system, and some luck.

In 1989, Poland elected its first democratic government after more than four decades of Communist rule. Since then, like many other Eastern European countries, Poland has embraced market-based economic policies, opened its markets to international trade and foreign investment, and privatized many state-owned businesses. In 2004 the country joined the European Union, giving it easy access to the large consumer markets of Western Europe. All this helped transform Poland into a major exporter. Exports account for about 40 percent of gross domestic product (in contrast, they account for around 12 percent in the United States). As a consequence, between 1989 and 2010 Poland recorded the highest sustained growth in the region. Real GDP doubled over this period, compared to a 70 percent increase in neighboring Slovakia and 45 percent in the Czech Republic.

Poland's government has also been fiscally conservative, keeping public debt in check, not allowing it to expand during the recession as many other countries did. This led to investor confidence in the country. As a result there was no large outflow of funds during the 2008–2009 economic turmoil. This stands in stark contrast to what happened in the Baltic states and Greece, where investors pulled money out of those economies during 2008 and 2009, driving their currencies down, raising the cost of government debt, and precipitating a full-blown economic crisis that required the IMF and EU to step in with financial assistance.

Poland also got lucky. A tight monetary squeeze in the early 2000s, which was designed to curb inflation and ease Poland's entry into the European Union, headed off the asset price bubble, particularly surging home prices, that hurt so many other economies around the world. Ironically, the Polish government had been criticized for its tight monetary policy earlier in the decade, but in 2008 and 2009 it served the country well. Moreover, in 2009 Poland benefited from the economic stimulus in neighboring Germany. A scheme to boost demand for German automobile companies by giving cash grants to people who exchanged old cars for new ones (a "cash for clunkers" program) helped Poland because the country has several automobile plants and was selling many cars and components to Germany.

None of this is to say that Poland is a model state. The country still has substantial problems. Migrant workers returning from Western Europe have swelled the ranks of the unemployed. In 2009 unemployment hit 11 percent. The tax system is complex and archaic. A study by the World Bank put the Polish tax system at 151st out of the 183 countries it surveyed. Extensive regulations can still make it difficult to do business in Poland; the World Bank ranked Poland 76th in ease of doing business. Even after 20 years, the transition from a socialist economy to a market-based system is still not complete and many state-owned enterprises remain.

On the other hand, the Polish government has committed itself to changing much of this. Steps are being taken to simplify tax laws, reduce tax rates, and remove bureaucratic hurdles to doing business in the country. An example was the Entrepreneurship Law passed in March 2009, which dramatically reduced the number of health, labor, and tax controls that companies had to comply with, making it much easier to start a business in the country. Also, after a six-year standstill, Poland privatized state-owned enterprises that accounted for 0.6 percent of GDP in 2009, and those accounting for another 2.5 percent of GDP in 2010.[1]

45

Opening Case

Cases



64 Part 2 Country Differences

5. Read the Country Focus on Chavez's Venezuela, then answer the following questions:
   a. Under Chavez's leadership, what kind of economic system is being put in place in Venezuela? How would you characterize the political system?
   b. How do you think that Chavez's unilateral changes to contracts with foreign oil companies will impact future investment by foreigners in Venezuela?
   c. How will the high level of public corruption in Venezuela impact future growth rates?
   d. Currently Venezuela is benefiting from a boom in oil prices. What do you think might happen if oil prices retreat from their current high level?
   e. In your estimation, what is the long-run prognosis for the Venezuelan economy? Is this a country that is attractive to international businesses?

Research Task globalEDGE globaledge.msu.edu

National Differences in Political Economy

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The definition of words and political ideas can have different meanings in different contexts worldwide. In fact, the *Freedom in the World* survey evaluates the state of political rights and civil liberties around the world. Provide a description of this survey and a ranking (in terms of "freedom") of the world's leaders and laggards. What factors are taken into consideration in this survey?

Exercise 2

One way that experts analyze conditions in emerging markets is through the use of economic indicators. The *Market Potential Index* (MPI) is a yearly study conducted by the Michigan State University Center for International Business Education and Research (MSU-CIBER) to compare emerging markets on a variety of dimensions. Provide a description of the indicators used in the index. Which of the indicators would have greater importance for a company that markets laptop computers? Considering the MPI rankings, which developing countries would you advise such a company to enter first?

CLOSING CASE

Indonesia—Asia's Stumbling Giant

Indonesia is a vast country. Its 220 million people are spread out over some 17,000 islands that span an arc 3,200 miles long from Sumatra in the west to Irian Jaya in the east. It is the world's most populous Muslim nation—some 85 percent of the population count themselves as Muslims—but also one of the most ethnically diverse. More than 500 languages are spoken in the country, and separatists are active in a number of provinces. For 30 years the strong arm of President Suharto held this sprawling nation together. Suharto was a virtual dictator who was backed by the military establishment. Under his rule, the Indonesian economy grew steadily, but there was a cost. Suharto brutally repressed internal dissent. He was also famous for "crony capitalism," using his command of the political system to favor the business enterprises of his supporters and family.

In the end, Suharto was overtaken by massive debts that Indonesia had accumulated during the 1990s. In 1997, the Indonesian economy went into a tailspin. The International Monetary Fund stepped in with a $43 billion rescue package. When it was revealed that much of this money found its way into the personal coffers of Suharto and his cronies, people took to the streets in protest and he was forced to resign.

After Suharto, Indonesia moved rapidly toward a vigorous democracy, culminating in October 2004 with the inauguration of Susilo Bambang Yudhoyono, the country's

Closing Case

Each chapter concludes with a closing case demonstrating the relevance of the chapter material to the practice of international business.



42 Part 1 Cases

The Globalization of Health Care

It has long been thought that health care is one of the industries least vulnerable to dislocation from globalization. After all, like many service businesses, health care is normally delivered where it is purchased. However, for some activities and procedures, this is now fast changing. The trend began with certain diagnostic procedures, such as MRI scans. The United States has a shortage of radiologists, the doctors who specialize in reading and interpreting diagnostic medical images, including X-rays, CT scans, MRI scans, and ultrasounds. Demand for radiologists has been growing twice as fast as the rate at which medical schools are graduating radiologists with the skills and qualifications required to read medical images. This imbalance between supply and demand means that radiologists are expensive; an American radiologist can earn as much as $400,000 a year. In the early 2000s, an Indian radiologist working at the Massachusetts General Hospital, Dr. Sanjay Saini, found a way to deal with the shortage and expense—send images over the Internet to India, where they could be interpreted by radiologists. This would reduce the workload on America's radiologists and also cut costs. A radiologist in India might earn one-tenth of his or her U.S. counterpart. Plus, because India is on the opposite side of the globe, the images could be interpreted while it was nighttime in the United States and be ready for the attending physician when he or she arrived for work the following morning.

The globalization trend has now spilled over into surgery. In the fall of 2006, for example, Adrienne de Forrest of Colorado had hip surgery in Chennai, India, while Texan David Jones had triple bypass surgery in New Delhi. Both patients were uninsured. Dr. Forrest's surgery cost $8,000, and Jones's cost $16,000 including travel expenses. Had those operations been done in the United States, they would have cost $45,000 and $250,000, respectively. Forrest and Jones are not alone; in 2007 some 750,000 Americans traveled abroad for medical treatment. The consulting company Deloitte is forecasting the numbers to reach 10 million by 2012, which would be worth about $21 billion to those nations where the procedures are performed.

Some might be worried about the quality of medical care in other countries, but medical tourists typically go to new hospitals, most of which are private, where highly skilled physicians treat them, many of whom trained in the United States or Britain. The three largest recipient countries of American patients are Mexico (due to its proximity), India (where 450,000 were treated in 2007), and Singapore (where more than 400,000 were treated in 2007, and where the local medical schools are considered to be among the very best in the world). Costs in these countries generally run from 20 to 35 percent of those in the United States.

A number of factors are driving the globalization trend. First there is the high cost of medical care in the United States, which is the source of the largest number of patients. Then there is the fact that over 45 million Americans are uninsured and many more are "underinsured" and face high copayments for expensive procedures (although recent legislation in the United States should change this over the next five years). Many of these people find it far cheaper to fly abroad to get treatment. Third is the emergence of high-quality private hospital chains in places such as India and Singapore. Fourth, the rising costs of insuring their workforces are starting to persuade some large American companies to look abroad. And finally, some insurance companies are experimenting with payment for foreign treatment at internationally accredited hospitals. In 2008, for example, Aetna, a large insurer, launched a pilot scheme in partnership with Singaporean hospitals. Aetna started to give Americans the option to have procedures costing $20,000 or more in the United States performed in Singapore, where the company reckons that the quality of care is better than at the average American hospital.[1]

Case Discussion Questions

1. What are the facilitating developments that have allowed health care to start globalizing?
2. Who benefits from the globalization of health care? Who are the losers?
3. Are there any risks associated with the globalization of health care? Can these risks be mitigated? How?
4. On balance, do you think that the globalization of health care is a good thing, or not?

Source

[1]G. Colvin, "Think Your Job Can't Be Sent to India?" *Fortune*, December 13, 2004, p. 80; A. Pollack, "Who's Reading Your X-Ray," *The New York Times*, November 16, 2003, pp. 1, 9;. Anonymous, "Sun, sand and and scalpels", *The Economist*, March 10th, 2007, page 62. Anonymous, "Operating Profit", *The Economist*, August 16th, 2008, pp 74–76. R. Bailey, "Hips Abroad", *Reason*, May 2009, page 14.

End-of-Part Cases

Longer, end-of-part cases allow for more in-depth study of international companies.

Focus Boxes and Exercises

Country Focus

Each **Country Focus** example provides background on the political, economic, social, or cultural aspects of countries grappling with an international business issue.



CO IN' ‹Y FOCUS

Chavez's Venezuela

Hugo Chavez, a former military officer who was once jailed for engineering a failed coup attempt, was elected president of Venezuela in 1998. Chavez, a self-styled democratic socialist, won the presidential election by campaigning against corruption, economic mismanagement, and the "harsh realities" of global capitalism. When he took office in February 1999, Chavez claimed he had inherited the worst economic situation in the country's recent history. He wasn't far off the mark. A collapse in the price of oil, which accounted for 70 percent of the country's exports, left Venezuela with a large budget deficit and forced the economy into a deep recession.

Soon after taking office, Chavez worked to consolidate his hold over the apparatus of government. A constituent assembly, dominated by Chavez followers, drafted a new constitution that strengthened the powers of the presidency and allowed Chavez (if reelected) to stay in office until 2012. Subsequently, the national congress, which was controlled by Chavez supporters, approved a measure allowing the government to remove and appoint Supreme Court justices, effectively increasing Chavez's hold over the judiciary. Chavez also extended government control over the media. By 2009, Freedom House, which annually assesses political and civil liberties worldwide, concluded Venezuela was only "partly free" and that freedoms were being progressively curtailed.

On the economic front, things remained rough. The economy shrank by 9 percent in 2002 and another 8 percent in 2003. Unemployment remained persistently high at 15 to 17 percent and the poverty rate rose to more than 50 percent of the population. A 2003 study by the World Bank concluded Venezuela was one of the most regulated economies in the world and that state controls over business activities gave public officials ample opportunities to enrich themselves by demanding bribes in return for permission to expand operations or enter new lines of business. Indeed, despite Chavez's anticorruption rhetoric, Transparency International, which ranks the world's nations according to the extent of public corruption, has noted that corruption has increased under Chavez. In 2011, Transparency International ranked Venezuela 164 out of 178 nations, down from 114 in 2004. Consistent with his socialist rhetoric, Chavez has progressively taken various enterprises into state ownership and has required that other enterprises be restructured as "workers' cooperatives" in return for government loans. In addition, the government has begun to seize large rural farms and ranches that Chavez claims are not sufficiently productive, turning them into state-owned cooperatives.

In 2004, the world oil market hailed Chavez out of mounting economic difficulties. Oil prices started to surge from the low $20s, reaching $150 a barrel by mid-2008, and Venezuela, the world's fifth-largest producer, started to reap a bonanza. On the back of surging oil exports, the economy grew at a robust rate. Chavez used the oil revenues to boost government spending on social programs, many of them modeled after programs in Cuba. As a result, the government's share of GDP increased from 20 percent at the end of the 1990s to almost 40 percent in 2008. Chavez also extended government control over foreign oil producers doing business in Venezuela, which he accused of making outsize profits at the expense of a poor nation. In 2005, he announced an increase in the royalties the government would collect from oil sales from 1 percent to 30 percent, and he increased the tax rate on sales from 34 to 50 percent. In 2006, he announced plans to reduce the stakes held by foreign companies in oil projects in the Orinoco regions and to give the state-run oil company, Petroleos de Venezuela SA, a majority position. However, despite strong global demand, oil production in Venezuela appears to be slipping, having fallen every year since 2006. Moreover, when oil prices fell in 2008–2009, the Venezuelan economy went into reverse, shrinking by 3.3 percent in 2009 and 2.8 percent in 2010.

Riding a wave of popularity at home, in December 2006 Chavez won reelection as president. He celebrated his victory by stepping on the revolutionary accelerator. Parliament gave him the power to legislate by decree for 18 months, and a committee of his supporters started to draft a constitutional reform to turn Venezuela into an avowedly socialist country and to allow the president to stand for reelection indefinitely. However, in a sign that Chavez's popularity has limits, in a December 2, 2007, nationwide referendum, Venezuelan voters narrowly rejected a revised constitution that would have placed more power in Chavez's hands. Despite this, in late 2010 Chavez yet again persuaded the National Assembly, where his supporters dominated, to once more grant him the power to rule by decree for another 18 months.[7]

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Management Focus

Management Focus examples further illustrate the relevance of chapter material for the practice of international business.



MANAGEMENT FOCUS

Starbucks Wins Key Trademark Case in China

Starbucks has big plans for China. It believes the fast-growing nation will become the company's second-largest market after the United States. Starbucks entered the country in 1999, and by the end of 2007 it had more than 300. But in China, copycats of well-established Western brands are common. Starbucks too faced competition from a look-alike, Shanghai Xing Ba Ke Coffee Shop, whose stores closely matched the Starbucks format, right down to a green-and-white Xing Ba Ke circular logo that mimics Starbucks' ubiquitous logo. The name also mimics the standard Chinese translation for Starbucks. *Xing* means "star" and *Ba Ke* sounds like "bucks."

In 2003, Starbucks decided to sue Xing Ba Ke in Chinese court for trademark violations. Xing Ba Ke's general manager responded by claiming it was just an accident that the logo and name were so similar to that of Starbucks. He claimed the right to use the logo and name because Xing Ba Ke had registered as a company in Shanghai in 1999, before Starbucks entered the city. "I hadn't heard of Starbucks at the time," claimed the manager, "so how could I imitate its brand and logo?"

However, in January 2006 a Shanghai court ruled that Starbucks had precedence, in part because it had registered its Chinese name in 1998. The court stated that Xing Ba Ke's use of the name and similar logo was "clearly malicious" and constituted improper competition. The court ordered Xing Ba Ke to stop using the name and to pay Starbucks $62,000 in compensation. While the money involved here may be small, the precedent is not. In a country where violation of trademarks has been common, the courts seem to be signaling a shift toward greater protection of intellectual property rights. This is perhaps not surprising, since foreign governments and the World Trade Organization have been pushing China hard recently to start respecting intellectual property rights.[33]

regulations. These regulations oblige WTO members to grant and enforce patents lasting at least 20 years and copyrights lasting 50 years. Rich countries had to comply with the rules within a year. Poor countries, in which such protection generally was much weaker, had five years of grace, and the very poorest have 10 years.[32] (For further details of the TRIPS agreement, see Chapter 7.)

In addition to lobbying governments, firms can file lawsuits on their own behalf. For example, Starbucks won a landmark trademark copyright case in China against a copycat (see the accompanying Management Focus for details). Firms may also choose to stay out of countries where intellectual property laws are lax, rather than risk having their ideas stolen by local entrepreneurs. Firms also need to be on the alert to ensure that pirated copies of their products produced in countries with weak intellectual property laws don't turn up in their home market or in third countries. U.S. computer software giant Microsoft, for example, discovered that pirated Microsoft software, produced illegally in Thailand, was being sold worldwide as the real thing.

PRODUCT SAFETY AND PRODUCT LIABILITY

Product safety laws set certain safety standards to which a product must adhere. **Product liability** involves holding a firm and its officers responsible when a product causes injury, death, or damage. Product liability can be much greater if a product does not conform to required safety standards. Both civil and criminal product liability laws exist. Civil laws call for payment and monetary damages. Criminal liability laws result in fines or imprisonment. Both civil and criminal liability laws are probably more

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extensive in the United States than in any other country, although many other Western nations also have comprehensive liability laws. Liability laws are typically least extensive in less developed nations. A boom in product liability suits and awards in the United States resulted in a dramatic increase in the cost of liability insurance. Many business executives argue that the high costs of liability insurance make American businesses less competitive in the global marketplace.

In addition to the competitiveness issue, country differences in product safety and liability laws raise an important ethical issue for firms doing business abroad. When product safety laws are tougher in a firm's home country than in a foreign country or when liability laws are more lax, should a firm doing business in that foreign country follow the more relaxed local standards or should it adhere to the standards of its home country? While the ethical thing to do is undoubtedly to adhere to home-country standards, firms have been known to take advantage of lax safety and liability laws to do business in a manner that would not be allowed at home.

IMPLICATIONS FOR MANAGERS

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The material discussed in this chapter has two broad implications for international business. First, the political, economic, and legal systems of a country raise important ethical issues that have implications for the practice of international business. For example, what ethical implications are associated with doing business in totalitarian countries where citizens are denied basic human rights, corruption is rampant, and bribes are necessary to gain permission to do business? Is it right to operate in such a setting? A full discussion of the ethical implications of country differences in political economy is reserved for Chapter 5, where we explore ethics in international business in much greater depth.

Second, the political, economic, and legal environments of a country clearly influence the attractiveness of that country as a market or investment site. The benefits, costs, and risks associated with doing business in a country are a function of that country's political, economic, and legal systems. The overall attractiveness of a country as a market or investment site depends on balancing the likely long-term benefits of doing business in that country against the likely costs and risks. Since this chapter is the first of two dealing with issues of political economy, we will delay a detailed discussion of how political economy impacts the benefits, costs, and risks of doing business in different nation-states until the end of the next chapter, when we have a full grasp of all the relevant variables that are important for assessing benefits, costs, and risks.

For now, other things being equal, a nation with democratic political institutions, a market-based economic system, and strong legal system that protects property rights and limits corruption is clearly more attractive as a place in which to do business than a nation that lack democratic institutions, where economic activity is heavily regulated by the state, and where corruption is rampant and the rule of law is not respected. On this basis, for example, Poland is a better place in which to do business than the Venezuela of Hugo Chavez (see the opening case and the Country Focus on Venezuela). That being said, the reality is often more nuanced and complex. For example, China lacks democratic institutions, corruption is widespread, property rights are not always respected, and even though the country has embraced many market-based economic reforms, there are still large numbers of state-owned enterprises, yet many Western businesses feel that they must invest in China. They do so despite the risks because the market is

Implications for Managers

At the end of each chapter in Parts 2, 3, and 4—where the focus is on the environment of international business, as opposed to particular firms—sections titled "Implications for Managers" clearly explain the managerial implications of material discussed in the chapter.

globalEDGE Research Task

Using the text and the **globalEDGE** website, http://globaledge.msu.edu, students solve realistic international business problems related to each chapter. These exercises expose students to the types of tools and data sources international managers use to make informed business decisions.



64 Part 2 Country Differences

5. Read the Country Focus on Chavez's Venezuela, then answer the following questions:
   a. Under Chavez's leadership, what kind of economic system is being put in place in Venezuela? How would you characterize the political system?
   b. How do you think that Chavez's unilateral changes to contracts with foreign oil companies will impact future investment by foreigners in Venezuela?
   c. How will the high level of public corruption in Venezuela impact future growth rates?
   d. Currently Venezuela is benefiting from a boom in oil prices. What do you think might happen if oil prices retreat from their current high level?
   e. In your estimation, what is the long-run prognosis for the Venezuelan economy? Is this a country that is attractive to international businesses?

Research Task globaledge.msu.edu

National Differences in Political Economy

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The definition of words and political ideas can have different meanings in different contexts worldwide. In fact, the *Freedom in the World* survey evaluates the state of political rights and civil liberties around the world. Provide a description of this survey and a ranking (in terms of "freedom") of the world's leaders and laggards. What factors are taken into consideration in this survey?

Exercise 2

One way that experts analyze conditions in emerging markets is through the use of economic indicators. The *Market Potential Index* (MPI) is a yearly study conducted by the Michigan State University Center for International Business Education and Research (MSU-CIBER) to compare emerging markets on a variety of dimensions. Provide a description of the indicators used in the index. Which of the indicators would have greater importance for a company that markets laptop computers? Considering the MPI rankings, which developing countries would you advise such a company to enter first?

CLOSING CASE

Indonesia—Asia's Stumbling Giant

Indonesia is a vast country. Its 220 million people are spread out over some 17,000 islands that span an arc 3,200 miles long from Sumatra in the west to Irian Jaya in the east. It is the world's most populous Muslim nation—some 85 percent of the population count themselves as Muslims—but also one of the most ethnically diverse. More than 300 languages are spoken in the country, and separatists are active in a number of provinces. For 30 years the strong arm of President Suharto held this sprawling nation together. Suharto was a virtual dictator who was backed by the military establishment. Under his rule, the Indonesian economy grew steadily, but there was a cost. Suharto brutally repressed internal dissent. He was also famous for "cronycapitalism," using his command of the political system to favor the business enterprises of his supporters and family.

In the end, Suharto was overtaken by massive debts that Indonesia had accumulated during the 1990's. In 1997, the Indonesian economy went into a tailspin. The International Monetary Fund stepped in with a $43 billion rescue package. When it was revealed that much of this money found its way into the personal coffers of Suharto and his cronies, people took to the streets in protest and he was forced to resign.

After Suharto, Indonesia moved rapidly toward a vigorous democracy, culminating in October 2004 with the inauguration of Susilo Bambang Yudhoyono, the country's

Supplements for the Instructor

Online Learning Center (OLC)—www.mhhe.com/hill

A password-protected portion of the book's website will be available to adopters of *International Business,* featuring online access to the instructor's manual, PowerPoint presentations, video cases, and globalEDGE answers. Instructors can also view student resources to make more effective supplementary assignments.

For students, this website also provides rich interactive resources to help them learn how to practice international business, including chapter quizzes and interactive modules.

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A new **Video** collection features recent news footage. Videos correspond to video teaching notes accessible on the instructor's side of the Online Learning Center.

An updated **Instructor's Manual and Video Guide** (prepared by Veronica Horton) includes course outlines, chapter overviews and teaching suggestions, lecture outlines, ideas for student exercises and projects, teaching notes for all cases in the book, and video notes.

PowerPoint

Two sets of slides per chapter (one prepared by Veronica Horton, one by Steve Lawton of Oregon State University) feature original materials not found in the text in addition to reproductions of key text figures, tables, and maps.

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International Business

COMPETING IN THE GLOBAL MARKETPLACE



part one Introduction and Overview

1 Globalization

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Understand what is meant by the term *globalization*.
- **LO2** Recognize the main drivers of globalization.
- **LO3** Describe the changing nature of the global economy.
- **LO4** Explain the main arguments in the debate over the impact of globalization.
- **LO5** Understand how the process of globalization is creating opportunities and challenges for business managers.

Legal Outsourcing

Sacha Baron Cohen, the irreverent British comedian whose fictional characters have included Borat, Ali G, and Bruno, is no stranger to lawsuits, including several from members of the public who claimed they were duped into appearing in his 2006 film, *Borat: Cultural Learnings of America for Make Benefit Glorious Nation of Kazakhstan*. In 2009, Cohen was sued yet again, this time by a woman who claimed Cohen defamed her during a sketch in the *Da Ali G Show,* in which Cohen plays the linguistically challenged rap star Ali G. Like most other suits against Cohen, this one was dismissed. In rendering his opinion, Los Angeles Superior Court Judge Terry Friedman stated, "No reasonable person could consider the statements made by Ali G on the program to be factual. It is obvious that the Ali G character is absurd, and all his statements are gibberish and intended as comedy."

An interesting aspect of this case was that the majority of the preparatory work was done not by lawyers in Los Angeles but by a six-member team of lawyers and legal assistants in Mysore, India. A veteran media lawyer noted that without legal outsourcing to somewhere such as India, mounting a defense against this kind of lawsuit would not have made economic sense. The defendants would have simply paid the plaintiff to go away to avoid paying U.S. legal fees, even though the case had no merit. But with a team of excellent Indian attorneys trained in U.S. law doing a major chunk of the legal work, it was less expensive to fight and win the suit than it was to settle out of court.

Legal outsourcing to places such as India and the Philippines is growing. Although the amounts involved are still small—estimates suggest that of the $180 billion Americans spend on legal services each year only about $1 billion is outsourced—the growth rate is high at 20 to 30 percent annually. The driving force has been spiraling legal fees in the United States. Between 1998 and 2009, hourly rates at big American law firms shot up more than 65 percent, according to industry sources.

Faced with escalating costs, law firms and corporate law departments are exploring outsourcing. Some legal tasks cannot be done cheaply. If the fate of your company



hangs on the verdict, you will probably want a brilliant lawyer to argue your case. However, plenty of legal tasks are routine. These include reviewing documents, drafting contracts, and the like. American law firms typically use fresh law graduates to do such grunt work, billing them out at steep rates to generate lots of profit for the firm. The 2008–2009 recession promoted clients to rebel against this practice. Increasingly, clients are pushing their law firms to drive down legal costs through outsourcing. While hourly rates for U.S. lawyers doing grunt work can run from $100 to as high as $500, lawyers in India will do the work for between $20 and $60 an hour, resulting in significant cost savings.

One major beneficiary of this trend has been an outsourcing company known as Pangea3. Founded in 2004 by David Perla, the former general counsel of Monster.com, Pangea3 has headquarters in New York and Mumbai, India, and a staff of more than 450. India is favored because local universities produce a steady stream of lawyers trained in common law, which is the legal tradition India inherited from the British. The same tradition underlies American law. Also, educated Indians speak good English, and the 10- to 12-hour time difference between India and the United States means that work can be done overnight in India, increasing responsiveness to clients.

Pangea3 serves two kinds of clients, corporations and U.S. law firms seeking to outsource routine legal work to low-cost locations. Some 75 percent of its business comes from Fortune 1000 companies, while the rest comes from law firms. Pangea3's value proposition is simple: It helps companies and law firms improve their efficiency, and minimize their business and legal risks, by having routine, labor-intensive legal work that requires a low degree of judgment done in India. Most industry experts believe that in the short to medium term, companies such as Pangea3 will see their market opportunity expand from about $1 billion today to $3 billion to $5 billion by decade's end. In anticipation of this rapid growth, Thomson Reuters, one of the world's largest media and information services companies, bought Pangea3 in November 2010.[1]

Introduction

Over the past three decades a fundamental shift has been occurring in the world economy. We have been moving away from a world in which national economies were relatively self-contained entities, isolated from each other by barriers to cross-border trade and investment; by distance, time zones, and language; and by national differences in government regulation, culture, and business systems. And we are moving toward a world in which barriers to cross-border trade and investment are declining; perceived distance is shrinking due to advances in transportation and telecommunications technology; material culture is starting to look similar the world over; and national economies are merging into an interdependent, integrated global economic system. The process by which this is occurring is commonly referred to as *globalization*.

In today's interdependent global economy, an American might drive to work in a car designed in Germany that was assembled in Mexico by Ford from components made in the United States and Japan that were fabricated from Korean steel and Malaysian rubber. She may have filled the car with gasoline at a BP service station owned by a British multinational company. The gasoline could have been made from oil pumped out of a well off the coast of Africa by a French oil company that transported it to the United States in a ship owned by a Greek shipping line. While driving to work, the American might talk to her stockbroker (using a headset) on a Nokia cell phone that was designed in Finland and assembled in Texas using chip sets produced in Taiwan that were designed by Indian engineers working for Texas Instruments. She could tell the stockbroker to purchase shares in Deutsche Telekom, a German telecommunications firm that was transformed from a former state-owned monopoly into a global company by an energetic Israeli CEO. She may turn on the car radio, which was made in Malaysia by a Japanese firm, to hear a popular hip-hop song composed by a Swede and sung by a group of Danes in English who signed a record contract with a French music company to promote their record in America. The driver might pull into a drive-through Starbucks coffee shop managed by a Korean immigrant and order a "single, tall, nonfat latte" and chocolate-covered biscotti. The coffee beans came from Costa Rica and the chocolate from Peru, while the biscotti was made locally using an old Italian recipe. After the song ends, a news announcer might inform the American listener that antiglobalization protests at a meeting of the World Economic Forum in Davos, Switzerland, have turned violent. One protester has been killed. The announcer then turns to the next item, a story about how a financial crisis that started in the U.S. banking sector may trigger a global recession and is sending stock markets down all over the world.

This is the world in which we live. It is a world where the volume of goods, services, and investment crossing national borders has expanded faster than world output for more than half a century. It is a world where more than $4 trillion in foreign exchange transactions are made every day, where $15 trillion of goods and $3.7 trillion of services were sold across national borders in 2010.[2] It is a world in which international institutions such as the World Trade Organization and gatherings of leaders from the world's most powerful economies have repeatedly called for even lower barriers to cross-border trade and investment. It is a world where the symbols of material and popular culture are increasingly global: from Coca-Cola and Starbucks to Sony PlayStations, Samsung cell phones, MTV shows, Disney films, IKEA stores, and Apple iPods and iPhones. It is a world in which products are made from inputs that come from all over the world. It is a world in which a financial crisis in America can trigger a global economic recession, which is exactly what occurred in 2008 and 2009. It is also a world in which vigorous and vocal groups protest against globalization, which they blame for a list of ills, from unemployment in developed nations to environmental degradation and the Americanization of popular culture. And yes, these protests have on occasion turned violent.

For businesses, this globalization process has produced many opportunities. Firms can expand their revenues by selling around the world and/or reduce their costs by producing in nations where key inputs, including labor, are cheap. The global expansion of

enterprises has been facilitated by favorable political and economic trends. Since the collapse of communism at the end of the 1980s, the pendulum of public policy in nation after nation has swung toward the free market end of the economic spectrum. Regulatory and administrative barriers to doing business in foreign nations have been reduced, while those nations have often transformed their economies, privatizing state-owned enterprises, deregulating markets, increasing competition, and welcoming investment by foreign businesses. This has allowed businesses both large and small, from both advanced nations and developing nations, to expand internationally.

The history of Starbucks exemplifies the opportunities that a global economy offers businesses. The original idea for Starbucks came from Italian coffeehouses. After refining the concept in the United States, in 1995 the company started to expand globally. As a result, a company that had only a handful of stores 25 years ago is now one of the world's best-known brands with almost 17,000 stores in 50 countries. Starbucks has had an impact on consumer behavior around the world, changing the way people consume coffee and profiting in the process. The company is also changing the way coffee is produced. By committing itself to purchasing only Fair Trade Certified coffee beans, Starbucks is promoting nonexploitive and environmentally sound growing policies in developing nations, and finding that doing good is also good business, since it reinforces the value of the Starbucks brand.

The opening case, which looks at the process of outsourcing legal services to lower-cost locations, is indicative of what is occurring in today's global economy. Law firms are starting to outsource to places such as India routine legal work that does not require much judgment or subjective review. They have found the work can be done just as effectively in India as in the United States, and at a much lower cost. Twenty years ago this would not have been possible, but because of rapid advances in telecommunications and the removal of barriers to cross-border trade and investment, such outsourcing is becoming increasingly common.

As globalization unfolds, it is transforming industries and creating anxiety among those who believed their jobs were protected from foreign competition. Historically, while many workers in manufacturing industries worried about the impact foreign competition might have on their jobs, workers in service industries felt more secure. Now this too is changing. Advances in technology, lower transportation costs, and the rise of skilled workers in developing countries imply that many services no longer need to be performed where they are delivered. As the opening case illustrates, some legal work is being outsourced to India. The same is true of some accounting services. Today many individual U.S. tax returns are compiled in India. Indian accountants, trained in U.S. tax rules, perform work for U.S. accounting firms.[3] They access individual tax returns stored on computers in the United States, perform routine calculations, and save their work so that it can be inspected by a U.S. accountant, who then bills clients. As the best-selling author Thomas Friedman has argued, the world is becoming flat.[4] People living in developed nations no longer have the playing field tilted in their favor. Increasingly, enterprising individuals based in India, China, or Brazil have the same opportunities to better themselves as those living in Western Europe, the United States, or Canada.

In this book we will take a close look at the issues introduced here and many more. We will explore how changes in regulations governing international trade and investment, when coupled with changes in political systems and technology, have dramatically altered the competitive playing field confronting many businesses. We will discuss the resulting opportunities and threats and review the strategies that managers can pursue to exploit the opportunities and counter the threats. We will consider whether globalization benefits or harms national economies. We will look at what economic theory has to say about the outsourcing of manufacturing and service jobs to places such as India and China, and at the benefits and costs of outsourcing, not just to business firms and their employees, but also to entire economies. First, though, we need to get a better overview of the nature and process of globalization, and that is the function of the current chapter.

LO1

What Is Globalization?

As used in this book, **globalization** refers to the shift toward a more integrated and interdependent world economy. Globalization has several facets, including the globalization of markets and the globalization of production.

THE GLOBALIZATION OF MARKETS

The **globalization of markets** refers to the merging of historically distinct and separate national markets into one huge global marketplace. Falling barriers to cross-border trade have made it easier to sell internationally. It has been argued for some time that the tastes and preferences of consumers in different nations are beginning to converge on some global norm, thereby helping to create a global market.[5] Consumer products such as Citigroup credit cards, Coca-Cola soft drinks, Sony PlayStation video games, McDonald's hamburgers, Starbucks coffee, and IKEA furniture are frequently held up as prototypical examples of this trend. Firms such as those just cited are more than just benefactors of this trend; they are also facilitators of it. By offering the same basic product worldwide, they help to create a global market.

A company does not have to be the size of these multinational giants to facilitate, and benefit from, the globalization of markets. In the United States, for example, nearly 90 percent of firms that export are small businesses employing less than 100 people, and their share of total U.S. exports has grown steadily over the past decade to now exceed 20 percent.[6] Firms with less than 500 employees accounted for 97 percent of all U.S. exporters and almost 30 percent of all exports by value.[7] Typical of these is Hytech, a New York-based manufacturer of solar panels that generates 40 percent of its $3 million in annual sales from exports to five countries, or B&S Aircraft Alloys, another New York company whose exports account for 40 percent of its $8 million annual revenues.[8] The situation is similar in several other nations. For example, in Germany, the world's largest exporter, a staggering 98 percent of small and midsize companies have exposure to international markets, via either exports or international production.[9]

Despite the global prevalence of Citigroup credit cards, McDonald's hamburgers, Starbucks coffee, and IKEA stores, it is important not to push too far the view that national markets are giving way to the global market. As we shall see in later chapters, significant differences still exist among national markets along many relevant dimensions, including consumer tastes and preferences, distribution channels, culturally embedded value systems, business systems, and legal regulations. These differences frequently require companies to customize marketing strategies, product features, and operating practices to best match conditions in a particular country.



Shoppers walk through Beijing's main downtown shopping promenade past a KFC franchise. KFC is one of the most successful international businesses in China because of its adaptation and appeal to the Chinese market.

The most global markets currently are not markets for consumer products—where national differences in tastes and preferences are still often important enough to act as a brake on globalization—but markets for industrial goods and materials that serve a universal need the world over. These include the markets for commodities such as aluminum, oil, and wheat; for industrial products such as microprocessors, DRAMs (computer memory chips), and commercial jet aircraft; for computer software; and for financial assets from U.S. Treasury bills to Eurobonds and futures on the Nikkei index or the euro.

In many global markets, the same firms frequently confront each other as competitors in nation after nation. Coca-Cola's rivalry with PepsiCo is a global one,

as are the rivalries between Ford and Toyota, Boeing and Airbus, Caterpillar and Komatsu in earthmoving equipment, General Electric and Rolls-Royce in aero engines, and Sony, Nintendo, and Microsoft in video games. If a firm moves into a nation not currently served by its rivals, many of those rivals are sure to follow to prevent their competitor from gaining an advantage.[10] As firms follow each other around the world, they bring with them many of the assets that served them well in other national markets—their products, operating strategies, marketing strategies, and brand names—creating some homogeneity across markets. Thus, greater uniformity replaces diversity. In an increasing number of industries, it is no longer meaningful to talk about "the German market," "the American market," "the Brazilian market," or "the Japanese market"; for many firms there is only the global market.

THE GLOBALIZATION OF PRODUCTION

The **globalization of production** refers to the sourcing of goods and services from locations around the globe to take advantage of national differences in the cost and quality of **factors of production** (such as labor, energy, land, and capital). By doing this, companies hope to lower their overall cost structure or improve the quality or functionality of their product offering, thereby allowing them to compete more effectively. Consider Boeing's 777, a commercial jet airliner. Eight Japanese suppliers make parts for the fuselage, doors, and wings; a supplier in Singapore makes the doors for the nose landing gear; three suppliers in Italy manufacture wing flaps; and so on.[11] In total, some 30 percent of the 777, by value, is built by foreign companies. For its most recent jet airliner, the 787, Boeing has pushed this trend even further; some 65 percent of the total value of the aircraft is outsourced to foreign companies, 35 percent of which goes to three major Japanese companies.[12]

Part of Boeing's rationale for outsourcing so much production to foreign suppliers is that these suppliers are the best in the world at their particular activity. A global web of suppliers yields a better final product, which enhances the chances of Boeing winning a greater share of total orders for aircraft than its global rival Airbus Industrie. Boeing also outsources some production to foreign countries to increase the chance that it will



Boeing's new global product, the 787 airliner, rolls out.



MANAGEMENT FOCUS

Vizio and the Market for Flat Panel TVs

Operating sophisticated tooling in environments that must be kept absolutely clean, fabrication centers in South Korea, Taiwan, and Japan produce to exacting specifications sheets of glass twice as large as king-size beds. From there, the glass panels travel to Mexican plants located alongside the U.S. border. There they are cut to size, combined with electronic components shipped in from Asia and the United States, assembled into finished flat panel TVs, and loaded onto trucks bound for retail stores in the United States, where consumers spend over $35 billion a year on flat panel TVs.

The underlying technology for flat panel displays was invented in the United States in the late 1960s by RCA. But after RCA and rivals Westinghouse and Xerox opted not to pursue the technology, the Japanese company Sharp made aggressive investments in flat panel displays. By the early 1990s Sharp was selling the first flat panel screens, but as the Japanese economy plunged into a decade-long recession, investment leadership shifted to South Korean companies such as Samsung. Then the 1997 Asian crisis hit Korea hard, and Taiwanese companies seized leadership. Today, Chinese companies are starting to elbow their way into the flat panel display manufacturing business.

As production for flat panel displays migrates its way around the globe to low-cost locations, there are clear winners and losers. U.S. consumers have benefited from the falling prices of flat panel TVs and are snapping them up. Efficient manufacturers have taken advantage of globally dispersed supply chains to make and sell low-cost, high-quality flat panel TVs. Foremost among these has been the California-based company Vizio, founded by a Taiwanese immigrant. In just six years, sales of Vizio flat panel TVs ballooned from nothing to over $2 billion in 2008. In early 2009, the company was the largest provider to the U.S. market with a 21.7 percent share. Vizio, however, has fewer than 100 employees. These focus on final product design, sales, and customer service. Vizio outsources most of its engineering work, all of its manufacturing, and much of its logistics. For each of its models, Vizio assembles a team of supplier partners strung across the globe. Its 42-inch flat panel TV, for example, contains a panel from South Korea, electronic components from China, and processors from the United States, and it is assembled in Mexico. Vizio's managers scour the globe continually for the cheapest manufacturers of flat panel displays and electronic components. They sell most of their TVs to large discount retailers such as Costco and Sam's Club. Good order visibility from retailers, coupled with tight management of global logistics, allows Vizio to turn over its inventory every three weeks, twice as fast as many of its competitors, which allows major cost savings in a business where prices are falling continually.

On the other hand, the shift to flat panel TVs has caused pain in certain sectors of the economy, such as those firms that make traditional cathode ray TVs in high-cost locations. In 2006, for example, Japanese electronics manufacturer Sanyo laid off 300 employees at its U.S. factory, and Hitachi closed its TV manufacturing plant in South Carolina, laying off 200 employees. Sony and Hitachi both still make TVs, but they are flat panel TVs assembled in Mexico from components manufactured in Asia.[13]

win significant orders from airlines based in that country. For another example of a global web of activities, consider the example of Vizio profiled in the accompanying Management Focus.

Early outsourcing efforts were primarily confined to manufacturing activities, such as those undertaken by Boeing and Vizio; increasingly, however, companies are taking advantage of modern communications technology, particularly the Internet, to outsource service activities to low-cost producers in other nations. The Internet has allowed hospitals to outsource some radiology work to India, where images from MRI scans and the like are read at night while U.S. physicians sleep and the results are ready for them in the morning. Many software companies, including IBM and Microsoft, now use

Indian engineers to perform test functions on software designed in the United States. The time difference allows Indian engineers to run debugging tests on software written in the United States when U.S. engineers sleep, transmitting the corrected code back to the United States over secure Internet connections so it is ready for U.S. engineers to work on the following day. Dispersing value-creation activities in this way can compress the time and lower the costs required to develop new software programs. Other companies, from computer makers to banks, are outsourcing customer service functions, such as customer call centers, to developing nations where labor is cheaper. In another example from health care, in 2008 some 34,000 Filipinos were transcribing American medical files (such as audio files from doctors seeking approval from insurance companies for performing a procedure). Some estimates suggest the outsourcing of many administrative procedures in health care, such as customer service and claims processing, could reduce health care costs in America by as much as $70 billion.[14]

Robert Reich, who served as secretary of labor in the Clinton administration, has argued that as a consequence of the trend exemplified by companies such as Boeing, IBM, and Vizio, in many cases it is becoming irrelevant to talk about American products, Japanese products, German products, or Korean products. Increasingly, according to Reich, the outsourcing of productive activities to different suppliers results in the creation of products that are global in nature, that is, "global products."[15] But as with the globalization of markets, companies must be careful not to push the globalization of production too far. As we will see in later chapters, substantial impediments still make it difficult for firms to achieve the optimal dispersion of their productive activities to locations around the globe. These impediments include formal and informal barriers to trade between countries, barriers to foreign direct investment, transportation costs, and issues associated with economic and political risk. For example, government regulations ultimately limit the ability of hospitals to outsource the process of interpreting MRI scans to developing nations where radiologists are cheaper.

Nevertheless, the globalization of markets and production will continue. Modern firms are important actors in this trend, their very actions fostering increased globalization. These firms, however, are merely responding in an efficient manner to changing conditions in their operating environment—as well they should.

The Emergence of Global Institutions

As markets globalize and an increasing proportion of business activity transcends national borders, institutions are needed to help manage, regulate, and police the global marketplace, and to promote the establishment of multinational treaties to govern the global business system. Over the past half century, a number of important global institutions have been created to help perform these functions, including the **General Agreement on Tariffs and Trade (GATT)** and its successor, the World Trade Organization (WTO); the International Monetary Fund (IMF) and its sister institution, the World Bank; and the United Nations (UN). All these institutions were created by voluntary agreement between individual nation-states, and their functions are enshrined in international treaties.

The **World Trade Organization** (like the GATT before it) is primarily responsible for policing the world trading system and making sure nation-states adhere to the rules laid down in trade treaties signed by WTO member states. As of 2011, 154 nations that collectively accounted for 97 percent of world trade were WTO members, thereby giving the organization enormous scope and influence. The WTO is also responsible for facilitating the establishment of additional multinational agreements between WTO member states. Over its entire history, and that of the GATT before it, the WTO has promoted the lowering of barriers to cross-border trade and investment. In

doing so, the WTO has been the instrument of its member states, which have sought to create a more open global business system unencumbered by barriers to trade and investment between countries. Without an institution such as the WTO, the globalization of markets and production is unlikely to have proceeded as far as it has. However, as we shall see in this chapter and in Chapter 7 when we look closely at the WTO, critics charge that the organization is usurping the national sovereignty of individual nation-states.

The **International Monetary Fund** and the **World Bank** were both created in 1944 by 44 nations that met at Bretton Woods, New Hampshire. The IMF was established to maintain order in the international monetary system; the World Bank was set up to promote economic development. In the more than six decades since their creation, both institutions have emerged as significant players in the global economy. The World Bank is the less controversial of the two sister institutions. It has focused on making low-interest loans to cash-strapped governments in poor nations that wish to undertake significant infrastructure investments (such as building dams or roads).

The IMF is often seen as the lender of last resort to nation-states whose economies are in turmoil and whose currencies are losing value against those of other nations. During the past two decades, for example, the IMF has lent money to the governments of troubled states, including Argentina, Indonesia, Mexico, Russia, South Korea, Thailand, and Turkey. More recently, the IMF has taken a very proactive role in helping countries to cope with some of the effects of the 2008–2009 global financial crisis. IMF loans come with strings attached, however; in return for loans, the IMF requires nation-states to adopt specific economic policies aimed at returning their troubled economies to stability and growth. These requirements have sparked controversy. Some critics charge that the IMF's policy recommendations are often inappropriate; others maintain that by telling national governments what economic policies they must adopt, the IMF, like the WTO, is usurping the sovereignty of nation-states. We shall look at the debate over the role of the IMF in Chapter 11.

The **United Nations** was established October 24, 1945, by 51 countries committed to preserving peace through international cooperation and collective security.



The United Nations has the important goal of improving the well-being of people around the world.

Today nearly every nation in the world belongs to the United Nations; membership now totals 191 countries. When states become members of the United Nations, they agree to accept the obligations of the UN Charter, an international treaty that establishes basic principles of international relations. According to the charter, the UN has four purposes: to maintain international peace and security, to develop friendly relations among nations, to cooperate in solving international problems and in promoting respect for human rights, and to be a center for harmonizing the actions of nations. Although the UN is perhaps best known for its peacekeeping role, one of the organization's central mandates is the promotion of higher standards of living, full employment, and conditions of economic and social progress and development—all issues that are central to the creation of a vibrant global economy. As much as 70 percent of the work of the UN system is devoted to accomplishing this mandate. To do so, the UN works closely with other international institutions such as the World Bank. Guiding the work is the belief that eradicating poverty and improving the well-being of people everywhere are necessary steps in creating conditions for lasting world peace.[16]

Another institution in the news is the **G20tx**. Established in 1999, the G20 comprises the finance ministers and central bank governors of the 19 largest economies in the world, plus representatives from the European Union and the European Central Bank. Originally established to formulate a coordinated policy response to financial crises in developing nations, in 2008 and 2009 it became the forum though which major nations attempted to launch a coordinated policy response to the global financial crisis that started in America and then rapidly spread around the world, ushering in the first serious global economic recession since 1981.

Drivers of Globalization LO2

Two macro factors underlie the trend toward greater globalization.[17] The first is the decline in barriers to the free flow of goods, services, and capital that has occurred since the end of World War II. The second factor is technological change, particularly the dramatic developments in recent decades in communication, information processing, and transportation technologies.

DECLINING TRADE AND INVESTMENT BARRIERS

During the 1920s and 30s many of the world's nation-states erected formidable barriers to international trade and foreign direct investment. **International trade** occurs when a firm exports goods or services to consumers in another country. **Foreign direct investment (FDI)** occurs when a firm invests resources in business activities outside its home country. Many of the barriers to international trade took the form of high tariffs on imports of manufactured goods. The typical aim of such tariffs was to protect domestic industries from foreign competition. One consequence, however, was "beggar thy neighbor" retaliatory trade policies, with countries progressively raising trade barriers against each other. Ultimately, this depressed world demand and contributed to the Great Depression of the 1930s.

Having learned from this experience, the advanced industrial nations of the West committed themselves after World War II to removing barriers to the free flow of goods, services, and capital between nations.[18] This goal was enshrined in the General Agreement on Tariffs and Trade. Under the umbrella of GATT, eight rounds of negotiations among member states worked to lower barriers to the free flow of goods and services. The most recent negotiations to be completed, known as the Uruguay Round, were finalized in December 1993. The Uruguay Round further reduced trade barriers; extended GATT to cover services as well as manufactured goods; provided enhanced protection for patents, trademarks, and copyrights; and established the

TABLE 1.1

Average Tariff Rates on Manufactured Products as Percent of Value

	1913	1950	1990	2010
France	21%	18%	5.9%	3.9%
Germany	20	26	5.9	3.9
Italy	18	25	5.9	3.9
Japan	30	—	5.3	2.3
Holland	5	11	5.9	3.9
Sweden	20	9	4.4	3.9
Great Britain	—	23	5.9	3.9
United States	44	14	4.8	3.2

Source: 1913–90 data are from "Who Wants to Be a Giant?" *The Economist: A Survey of the Multinationals*, June 24, 1995, pp. 3–4. Copyright © The Economist Books, Ltd. The 2009 data are from World Trade Organization, *2010 World Trade Report* (Geneva: WTO, 2010).

World Trade Organization to police the international trading system.[19] Table 1.1 summarizes the impact of GATT agreements on average tariff rates for manufactured goods. As can be seen, average tariff rates have fallen significantly since 1950 and now stand at about 4 percent.

In late 2001, the WTO launched a new round of talks aimed at further liberalizing the global trade and investment framework. For this meeting, it picked the remote location of Doha in the Persian Gulf state of Qatar. At Doha, the member states of the WTO staked out an agenda. The talks were scheduled to last three years, but, as of 2011, the talks are effectively stalled due to opposition from several key nations. The Doha agenda includes cutting tariffs on industrial goods, services, and agricultural products; phasing out subsidies to agricultural producers; reducing barriers to cross-border investment; and limiting the use of antidumping laws. If the Doha talks are ever completed, the biggest gain may come from discussion on agricultural products; average agricultural tariff rates are still about 40 percent, and rich nations spend some $300 billion a year in subsidies to support their farm sectors. The world's poorer nations have the most to gain from any reduction in agricultural tariffs and subsidies; such reforms would give them access to the markets of the developed world.[20]

In addition to reducing trade barriers, many countries have also been progressively removing restrictions to foreign direct investment. According to the United Nations, some 90 percent of the 2,700 changes made worldwide between 1992 and 2009 in the laws governing foreign direct investment created a more favorable environment for FDI.[21]

Such trends have been driving both the globalization of markets and the globalization of production. The lowering of barriers to international trade enables firms to view the world, rather than a single country, as their market. The lowering of trade and investment barriers also allows firms to base production at the optimal location for that activity. Thus, a firm might design a product in one country, produce component parts in two other countries, assemble the product in yet another country, and then export the finished product around the world.

According to WTO data, the volume of world merchandise trade has grown faster than the world economy since 1950 (see Figure 1.1).[22] From 1970 to 2010, the volume of world merchandise trade expanded more than 30-fold, outstripping the expansion of world production, which grew close to 10 times in real terms. (World merchandise trade includes trade in manufactured goods, agricultural goods, and mining products, but *not* services.) Since the mid-1980s, the value of international trade in services has also grown robustly. Trade in services now accounts for about 20 percent of the value of all international trade. Increasingly, international trade in services has been driven by advances in communications, which allow corporations to outsource service activities to different locations around the globe (see the opening case). Thus, as noted earlier, many corporations in the developed world outsource customer service functions, from software testing to customer call centers, to developing nations where labor costs are lower.

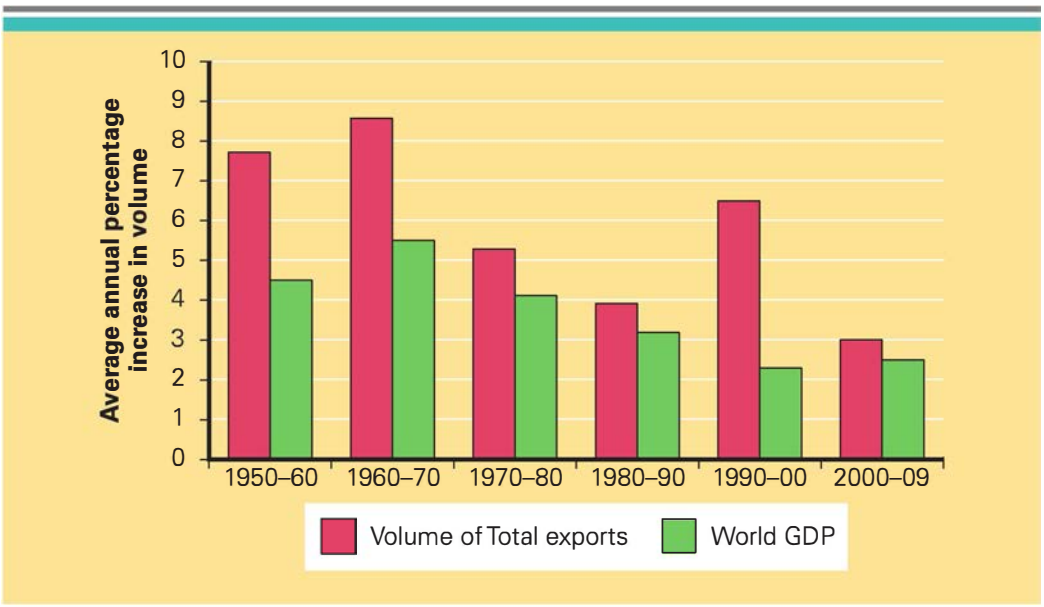


FIGURE 1.1

Average Annual Percentage Growth in Volume of Exports and World GDP, 1950–2009

Source: Constructed by the author from World Trade Organization, *World Trade Statistics 2010*.

It is worth noting that the relatively slow growth in trade during the 2000–2009 period that can be seen in Figure 1.1 reflects a steep drop in world trade that occurred in 2008 and 2009. In 2009 the global economy contracted by 2.3 percent as the global financial crisis that began with problems in the U.S. subprime mortgage lending market reverberated around the world. The volume of merchandised trade dropped by 12.2 percent in 2009, the largest such decline since World War II. The main reason seems to have been a drop in global consumer demand, although an inability to finance international trade due to tight credit conditions may have also played a role. However, trade did rebound in 2010, with the WTO forecasting a 14.5 percent growth in volume. Long-term trends still seem firmly in place.[23]

The data summarized in Figure 1.1 imply several things. First, more firms are doing what Boeing does with the 777 and 787: dispersing parts of their production process to different locations around the globe to drive down production costs and increase product quality. Second, the economies of the world's nation-states are becoming more intertwined. As trade expands, nations are becoming increasingly dependent on each other for important goods and services. Third, the world has become significantly wealthier since 1950, and the implication is that rising trade is the engine that has helped to pull the global economy along.

Evidence also suggests that foreign direct investment is playing an increasing role in the global economy as firms increase their cross-border investments. The average yearly outflow of FDI increased from $25 billion in 1975 to a record $1.8 trillion in 2007. However, FDI outflows did contract to $1.1 trillion in 2009 and 2010 in the wake of the global financial crisis, although they were forecasted to recover in 2011.[24] In general, over the past 30 years the flow of FDI has accelerated faster than the growth in world trade and world output. For example, between 1992 and 2008, the total flow of FDI from all countries increased more than eightfold while world trade by value grew by some 150 percent and world output by around 45 percent.[25] As a result of the strong FDI flow, by 2009 the global stock of FDI was about $15.5 trillion. At least 82,000 parent companies had 810,000 affiliates in foreign markets that collectively employed more than 77 million people abroad and generated value accounting for about 11 percent of global GDP. The foreign affiliates of multinationals had more than $30 trillion in global sales, higher than the value of global exports of goods and services, which stood at close to $19.9 trillion.[26]

The globalization of markets and production and the resulting growth of world trade, foreign direct investment, and imports all imply that firms are finding their home markets under attack from foreign competitors. This is true in Japan, where U.S. companies

such as Apple and Procter & Gamble are expanding their presence. It is true in the United States, where Japanese automobile firms have taken market share away from General Motors and Ford (although there are signs that this trend is now reversing). And it is true in Europe, where the once-dominant Dutch company Philips has seen its market share in the consumer electronics industry taken by Japan's JVC, Matsushita, and Sony, and Korea's Samsung and LG. The growing integration of the world economy into a single, huge marketplace is increasing the intensity of competition in a range of manufacturing and service industries.

However, declining barriers to cross-border trade and investment cannot be taken for granted. As we shall see in subsequent chapters, demands for "protection" from foreign competitors are still often heard in countries around the world, including the United States. Although a return to the restrictive trade policies of the 1920s and 30s is unlikely, it is not clear whether the political majority in the industrialized world favors further reductions in trade barriers. Indeed, the global financial crisis of 2008–2009 and the associated drop in global output that occurred led to more calls for trade barriers to protect jobs at home. If trade barriers decline no further, this may slow the rate of globalization of both markets and production.

THE ROLE OF TECHNOLOGICAL CHANGE

The lowering of trade barriers made globalization of markets and production a theoretical possibility. Technological change has made it a tangible reality. Since the end of World War II, the world has seen major advances in communication, information processing, and transportation technology, including the explosive emergence of the Internet and World Wide Web. Telecommunications is creating a global audience. Transportation is creating a global village. From Buenos Aires to Boston, and from Birmingham to Beijing, ordinary people are watching MTV, they're wearing blue jeans, and they're listening to iPods as they commute to work.

Microprocessors and Telecommunications

Perhaps the single most important innovation has been development of the microprocessor, which enabled the explosive growth of high-power, low-cost computing, vastly increasing the amount of information that can be processed by individuals and firms. The microprocessor also underlies many recent advances in telecommunications technology. Over the past 30 years, global communications have been revolutionized by developments in satellite, optical fiber, wireless technologies, and the Internet and the World Wide Web (WWW). These technologies rely on the microprocessor to encode, transmit, and decode the vast amount of information that flows along these electronic highways. The cost of microprocessors continues to fall, while their power increases (a phenomenon known as **Moore's Law**, which predicts that the power of microprocessor technology doubles and its cost of production falls in half every 18 months).[27] As this happens, the cost of global communications plummets, which lowers the costs of coordinating and controlling a global organization. Thus, between 1930 and 1990, the cost of a three-minute phone call between New York and London fell from $244.65 to $3.32.[28] By 1998, it had plunged to just 36 cents for consumers, and much lower rates were available for businesses.[29] Indeed, by using the Internet, the cost of an international phone call is rapidly plummeting toward zero.

The Internet and World Wide Web

The explosive growth of the World Wide Web since 1994 when the first web browser was introduced is the latest expression of this development. In 1990, fewer than 1 million users were connected to the Internet. By 1995, the figure had risen to 50 million. By 2010 the Internet had 1.97 billion users.[30] The WWW has developed into the information backbone of the global economy. In the United States alone, e-commerce retail sales reached $165 billion in 2010, up from almost nothing in 1998.[31] Viewed globally, the web is emerging as an equalizer. It rolls back some of the constraints of location,

scale, and time zones.[32] The web makes it much easier for buyers and sellers to find each other, wherever they may be located and whatever their size. It allows businesses, both small and large, to expand their global presence at a lower cost than ever before. It enables enterprises to coordinate and control a globally dispersed production system in a way that was not possible 20 years ago.

Transportation Technology

In addition to developments in communication technology, several major innovations in transportation technology have occurred since World War II. In economic terms, the most important are probably the development of commercial jet aircraft and superfreighters and the introduction of containerization, which simplifies transshipment from one mode of transport to another. The advent of commercial jet travel, by reducing the time needed to get from one location to another, has effectively shrunk the globe. In terms of travel time, New York is now "closer" to Tokyo than it was to Philadelphia in the Colonial days.

Containerization has revolutionized the transportation business, significantly lowering the costs of shipping goods over long distances. Before the advent of containerization, moving goods from one mode of transport to another was very labor intensive, lengthy, and costly. It could take days and several hundred longshoremen to unload a ship and reload goods onto trucks and trains. With the advent of widespread containerization in the 1970s and 1980s, the whole process can now be executed by a handful of longshoremen in a couple of days. Since 1980, the world's containership fleet has more than quadrupled, reflecting in part the growing volume of international trade and in part the switch to this mode of transportation. As a result of the efficiency gains associated with containerization, transportation costs have plummeted, making it much more economical to ship goods around the globe, thereby helping to drive the globalization of markets and production. Between 1920 and 1990, the average ocean freight and port charges per ton of U.S. export and import cargo fell from $95 to $29 (in 1990 dollars).[33] The cost of shipping freight per ton-mile on railroads in the United States fell from 3.04 cents in 1985 to 2.3 cents in 2000, largely as a result of efficiency gains from the widespread use of containers.[34] An increased share of cargo now goes by air. Between 1955 and 1999, average air transportation revenue per ton-kilometer fell by more than 80 percent.[35] Reflecting the falling cost of airfreight, by the early 2000s air shipments accounted for 28 percent of the value of U.S. trade, up from 7 percent in 1965.[36]

Implications for the Globalization of Production

As transportation costs associated with the globalization of production have declined, dispersal of production to geographically separate locations became more economical. As a result of the technological innovations discussed above, the real costs of information processing and communication have fallen dramatically in the past two decades. These developments make it possible for a firm to create and then manage a globally dispersed production system, further facilitating the globalization of production. A worldwide communications network has become essential for many international businesses. For example, Dell uses the Internet to coordinate and control a globally dispersed production system to such an extent that it holds only three days' worth of inventory at its assembly locations. Dell's Internet-based system records orders for computer equipment as they are submitted by customers via the company's website, then immediately transmits the resulting orders for components to various suppliers around the world, which have a real-time look at Dell's order flow and can adjust their production schedules accordingly. Given the low cost of airfreight, Dell can use air transportation to speed up the delivery of critical components to meet unanticipated demand shifts without delaying the shipment of final product to consumers. Dell also has used modern communications technology to outsource its customer service operations to India. When U.S. customers call Dell with a service inquiry, they are routed to Bangalore in India, where English-speaking service personnel handle the call.

The Internet has been a major force facilitating international trade in services. It is the web that allows hospitals in Chicago to send MRI scans to India for analysis, accounting offices in San Francisco to outsource routine tax preparation work to accountants living in the Philippines, and software testers in India to debug code written by developers in Redmond, Washington, the headquarters of Microsoft. We are probably still in the early stages of this development. As Moore's Law continues to advance and telecommunications bandwidth continues to increase, almost any work processes that can be digitalized will be, and this will allow that work to be performed wherever in the world it is most efficient and effective to do so.

The development of commercial jet aircraft has also helped knit together the worldwide operations of many international businesses. Using jet travel, an American manager need spend a day at most traveling to his or her firm's European or Asian operations. This enables the manager to oversee a globally dispersed production system.

Implications for the Globalization of Markets

In addition to the globalization of production, technological innovations have facilitated the globalization of markets. Low-cost global communications networks such as the World Wide Web are helping to create electronic global marketplaces. As noted above, low-cost transportation has made it more economical to ship products around the world, thereby helping to create global markets. For example, due to the tumbling costs of shipping goods by air, roses grown in Ecuador can be cut and two days later sold in New York. This has given rise to an industry in Ecuador that did not exist 20 years ago and now supplies a global market for roses. In addition, low-cost jet travel has resulted in the mass movement of people between countries. This has reduced the cultural distance between countries and is bringing about some convergence of consumer tastes and preferences. At the same time, global communication networks and global media are creating a worldwide culture. U.S. television networks such as CNN, MTV, and HBO are now received in many countries, and Hollywood films are shown the world over. In any society, the media are primary conveyors of culture; as global media develop, we must expect the evolution of something akin to a global culture. A logical result of this evolution is the emergence of global markets for consumer products. The first signs of this are already apparent. It is now as easy to find a McDonald's restaurant in Tokyo as it is in New York, to buy an iPod in Rio as it is in Berlin, and to buy Gap jeans in Paris as it is in San Francisco.

Despite these trends, we must be careful not to overemphasize their importance. While modern communication and transportation technologies are ushering in the "global village," significant national differences remain in culture, consumer preferences, and business practices. A firm that ignores differences between countries does so at its peril. We shall stress this point repeatedly throughout this book and elaborate on it in later chapters.

LO3 The Changing Demographics of the Global Economy

Hand in hand with the trend toward globalization has been a fairly dramatic change in the demographics of the global economy over the past 30 years. As late as the 1960s, four stylized facts described the demographics of the global economy. The first was U.S. dominance in the world economy and world trade picture. The second was U.S. dominance in world foreign direct investment. Related to this, the third fact was the dominance of large, multinational U.S. firms on the international business scene. The fourth was that roughly half the globe—the centrally planned economies of the communist world—was off-limits to Western international businesses. As will be explained below, all four of these qualities either have changed or are now changing rapidly.

Country	Share of World Output, 1963 (%)	Share of World Output, 2009 (%)	Share of World Exports, 2010 (%)
United States	40.3%	24.1%	8.6%
Germany	9.7	5.9	8.5
France	6.3	4.6	3.5
Italy	3.4	3.6	2.9
United Kingdom	6.5	4.3	4.3
Canada	3.0	1.9	2.4
Japan	5.5	8.2	5.2
China	NA	8.2	10.6

TABLE 1.2

The Changing Demographics of World Output and Trade

Sources: IMF, *World Economic Outlook*, October 2010. Data for 1963 are from N. Hood and J. Young, *The Economics of the Multinational Enterprise* (New York: Longman, 1973). The GDP data are based on purchasing power parity figures, which adjust the value of GDP to reflect the cost of living in various economies. Export data from WTO press release, "Trade Growth to Ease in 2011," April 7, 2011.

THE CHANGING WORLD OUTPUT AND WORLD TRADE PICTURE

In the early 1960s, the United States was still by far the world's dominant industrial power. In 1963 the United States accounted for 40.3 percent of world economic activity, measured by gross domestic product (GDP). By 2009, the United States accounted for 24.1 percent of world output (measured by gross national income, or GNI), still the world's largest industrial power but down significantly in relative size since the 1960s (see Table 1.2). Nor was the United States the only developed nation to see its relative standing slip. The same occurred to Germany, France, and the United Kingdom, all nations that were among the first to industrialize. This change in the U.S. position was not an absolute decline, since the U.S. economy grew significantly between 1963 and 2009 (the economies of Germany, France, and the United Kingdom also grew during this time). Rather, it was a relative decline, reflecting the faster economic growth of several other economies, particularly in Asia. For example, as can be seen from Table 1.2, from 1963 to 2009, China's share of world output increased from a trivial amount to 8.2 percent (and provisional data indicate that in 2010 China passed Japan to become the world's second-largest economy). Other countries that markedly increased their share of world output included Japan, Thailand, Malaysia, Taiwan, and South Korea.

By the end of the 1980s, the U.S. position as the world's leading exporter was threatened. Over the past 30 years, U.S. dominance in export markets has waned as Japan, Germany, and a number of newly industrialized countries such as South Korea and China have taken a larger share of world exports. During the 1960s, the United States routinely accounted for 20 percent of world exports of manufactured goods. But as Table 1.2 shows, the U.S. share of world exports of goods and services had slipped to 8.6 percent by 2010, behind that of China.

As emerging economies such as China, India, and Brazil continue to grow, a further relative decline in the share of world output and world exports accounted for by the United States and other long-established developed nations seems likely. By itself, this is not bad. The relative decline of the United States reflects the growing economic development and industrialization of the world economy, as opposed to any absolute decline in the health of the U.S. economy.

Most forecasts now predict a rapid rise in the share of world output accounted for by developing nations such as China, India, Russia, Indonesia, Thailand, South Korea, Mexico, and Brazil, and a commensurate decline in the share enjoyed by rich

COUNTRY FOCUS

India's Software Sector

Some 25 years ago a number of small software enterprises were established in Bangalore, India. Typical of these enterprises was Infosys Technologies, which was started by seven Indian entrepreneurs with about $1,000 between them. Infosys now has annual revenues of $22 billion and some 60,000 employees, but it is just one of over a hundred software companies clustered around Bangalore, which has become the epicenter of India's fast-growing information technology sector. From a standing start in the mid-1980s, by 2008–2009 this sector was generating revenues of $60 billion, and combined software services, hardware sales, and business process outsourcing exports were expected to hit $47 billion, a 16 percent growth rate achieved despite a sharp global economic slowdown during 2008–2009. India has also emerged as home to some of the fastest-growing software service companies on the planet, including Infosys, Wipro, Tata Consultancy Services, and HCL Technologies.

The growth of the Indian software sector is based on four factors. First, the country has an abundant supply of engineering talent. Every year Indian universities graduate some 400,000 engineers. Second, labor costs in India are low. The cost to hire an Indian graduate is roughly 12 percent of the cost of hiring an American graduate. Third, many Indians are fluent in English, which makes coordination between Western firms and India easier. Fourth, due to time differences, Indians can work while Americans sleep. This means, for example, that software code written in America during the day can be tested in India at night, and shipped back via the Internet to America in time for the start of work the following day. In other words, by utilizing Indian labor and the Internet, software enterprises can create global software development factories that are working 24 hours a day.

Initially Indian software enterprises focused on the low end of the software industry, supplying basic software development and testing services to Western firms. But as the industry has grown in size and sophistication, Indian firms have moved up the market. Today the leading Indian companies compete directly with the likes of IBM and EDS for large software development projects, business process outsourcing contracts, and information technology consulting services. These markets are booming. Estimates suggest that global spending on information technology outsourcing rose from $193 billion in 2004 to more than $250 billion in 2010, with Indian enterprises capturing a larger slice of the pie. One response of Western firms to this emerging competitive threat has been to invest in India to garner the same kind of economic advantages that Indian firms enjoy. IBM, for example, has invested $2 billion in its Indian operations and now has 53,000 employees located there, more than in any other country except America. In 2007 it announced plans to invest another $6 billion over the next few years in India. Microsoft too has made major investments in India, including an R&D center in Hyderabad that employs 4,000 people and was located there specifically to tap into talented Indian engineers who did not want to move to the United States.[37]

industrialized countries such as Great Britain, Germany, Japan, and the United States. If current trends continue, the Chinese economy could ultimately be larger than that of the United States on a purchasing power parity basis, while the economy of India will approach that of Germany. The World Bank has estimated that today's developing nations may account for more than 60 percent of world economic activity by 2020, while today's rich nations, which currently account for more than 55 percent of world economic activity, may account for only about 38 percent. Forecasts are not always correct, but these suggest that a shift in the economic geography of the world is now under way, although the magnitude of that shift is not totally evident. For international businesses, the implications of this changing economic geography are clear: Many of tomorrow's economic opportunities may be found in the developing nations of the world, and many of tomorrow's most capable competitors will probably also emerge from these regions. A case in point has been the dramatic expansion of India's software sector, which is profiled in the accompanying Country Focus.

THE CHANGING FOREIGN DIRECT INVESTMENT PICTURE

Reflecting the dominance of the United States in the global economy, U.S. firms accounted for 66.3 percent of worldwide foreign direct investment flows in the 1960s. British firms were second, accounting for 10.5 percent, while Japanese firms were a distant eighth, with only 2 percent. The dominance of U.S. firms was so great that books were written about the economic threat posed to Europe by U.S. corporations.[38] Several European governments, most notably France, talked of limiting inward investment by U.S. firms.

However, as the barriers to the free flow of goods, services, and capital fell, and as other countries increased their shares of world output, non-U.S. firms increasingly began to invest across national borders. The motivation for much of this foreign direct investment by non-U.S. firms was the desire to disperse production activities to optimal locations and to build a direct presence in major foreign markets. Thus, beginning in the 1970s, European and Japanese firms began to shift labor-intensive manufacturing operations from their home markets to developing nations where labor costs were lower. In addition, many Japanese firms invested in North America and Europe—often as a hedge against unfavorable currency movements and the possible imposition of trade barriers. For example, Toyota, the Japanese automobile company, rapidly increased its investment in automobile production facilities in the United States and Europe during the late 1980s and early 1990s. Toyota executives believed that an increasingly strong Japanese yen would price Japanese automobile exports out of foreign markets; therefore, production in the most important foreign markets, as opposed to exports from Japan, made sense. Toyota also undertook these investments to head off growing political pressures in the United States and Europe to restrict Japanese automobile exports into those markets.

One consequence of these developments is illustrated in Figure 1.2, which shows how the stock of foreign direct investment by the world's six most important national sources—the United States, the United Kingdom, Germany, the Netherlands, France, and Japan—changed between 1980 and 2009. (The **stock of foreign direct investment** refers to the total cumulative value of foreign investments.) Figure 1.2 also shows the stock accounted for by firms from developing economies. The share of the total stock accounted for by U.S. firms declined from about 38 percent in 1980 to 23 percent in 2009. Meanwhile, the shares accounted for by France and the world's developing nations increased markedly. The rise in the share of FDI stock accounted for by developing nations reflects a growing trend for firms from these countries to invest outside their

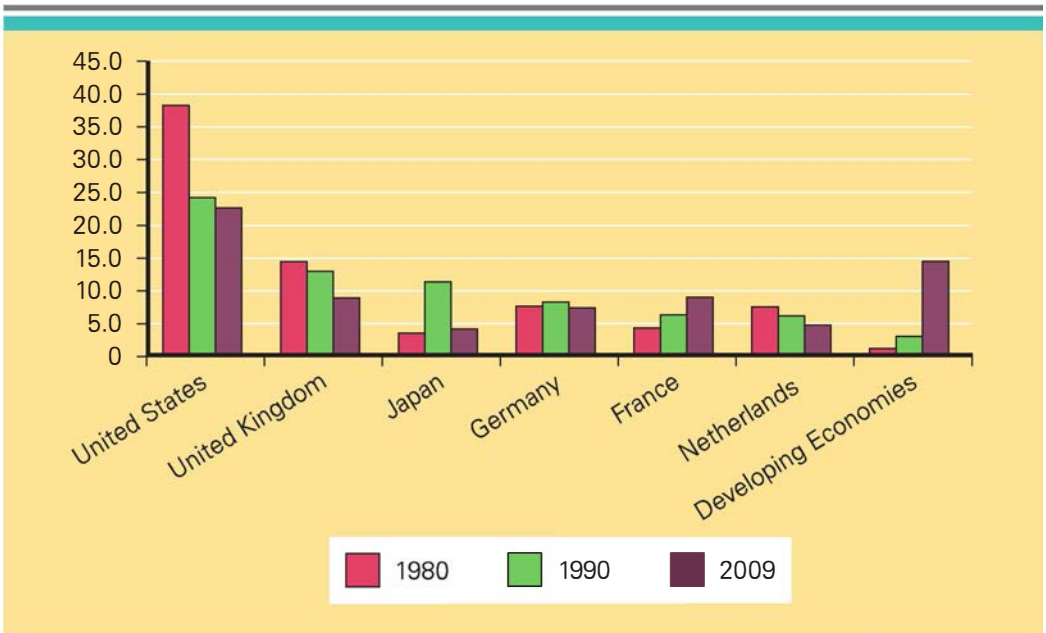


FIGURE 1.2

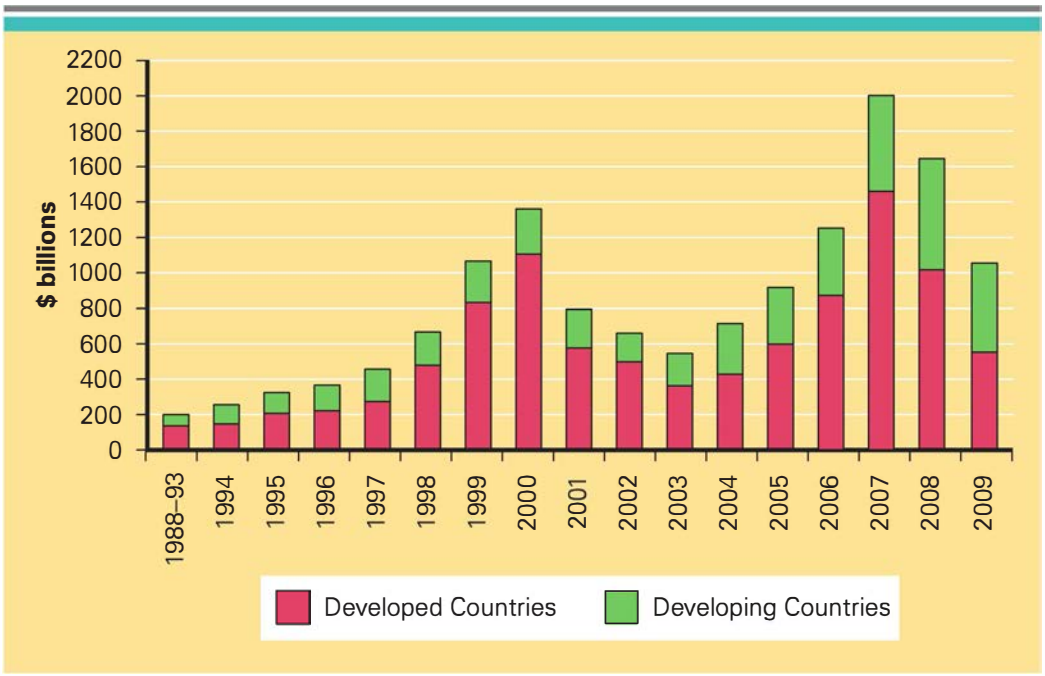
Percentage Share of Total FDI Stock, 1980–2009

Source: UNCTAD, *World Investment Report, 2009* (Geneva: United Nations, 2009).

FIGURE 1.3

FDI Inflows, 1988–2009

Source: UNCTAD, *World Investment Report, 2010* (Geneva: United Nations, 2010).



borders. In 2009, firms based in developing nations accounted for 14.1 percent of the stock of foreign direct investment, up from only 1.1 percent in 1980. Firms based in Hong Kong, South Korea, Singapore, Taiwan, India, and mainland China accounted for much of this investment.

Figure 1.3 illustrates two other important trends—the sustained growth in cross-border flows of foreign direct investment that occurred during the 1990s and the importance of developing nations as the destination of foreign direct investment. Throughout the 1990s, the amount of investment directed at both developed and developing nations increased dramatically, a trend that reflects the increasing internationalization of business corporations. A surge in foreign direct investment from 1998 to 2000 was followed by a slump from 2001 to 2003 associated with a slowdown in global economic activity after the collapse of the financial bubble of the late 1990s and 2000. However, the growth of foreign direct investment resumed in 2004 and continued through 2007, when it hit record levels, only to slow again in 2008 and 2009 as the global financial crisis took hold. Among developing nations, the largest recipient of foreign direct investment has been China, which in 2004–2009 received $60 billion to $100 billion a year in inflows. As we shall see later in this book, the sustained flow of foreign investment into developing nations is an important stimulus for economic growth in those countries, which bodes well for the future of countries such as China, Mexico, and Brazil, all leading beneficiaries of this trend.

THE CHANGING NATURE OF THE MULTINATIONAL ENTERPRISE

A **multinational enterprise (MNE)** is any business that has productive activities in two or more countries. Since the 1960s, two notable trends in the demographics of the multinational enterprise have been (1) the rise of non-U.S. multinationals and (2) the growth of mini-multinationals.

Non-U.S. Multinationals

In the 1960s, global business activity was dominated by large U.S. multinational corporations. With U.S. firms accounting for about two-thirds of foreign direct investment during the 1960s, one would expect most multinationals to be U.S. enterprises. According to the data summarized in Figure 1.4, in 1973, 48.5 percent of the world's 260 largest

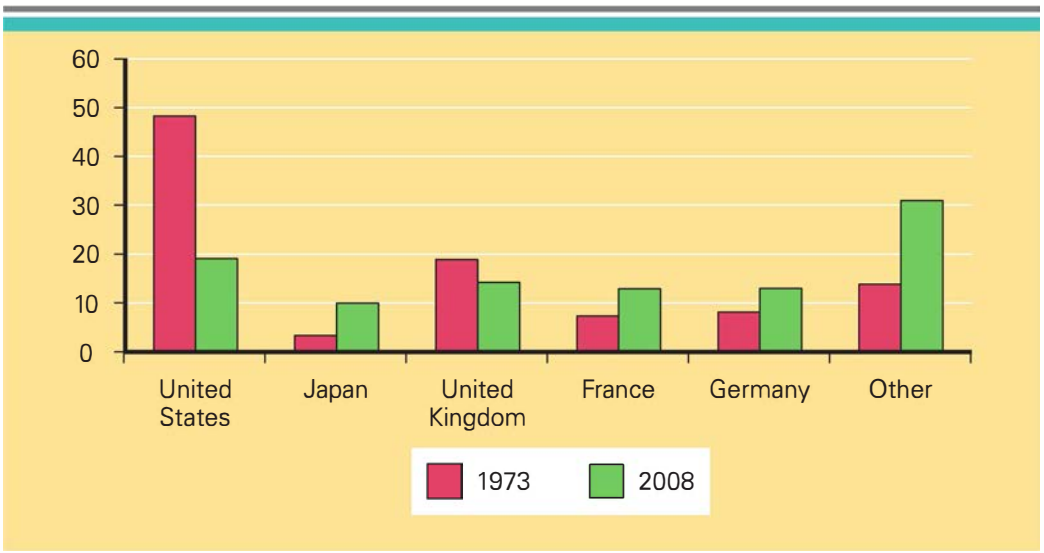


FIGURE 1.4

National Origin of Largest Multinational Enterprises, 1973 and 2008

multinationals were U.S. firms. The second-largest source country was the United Kingdom, with 18.8 percent of the largest multinationals. Japan accounted for 3.5 percent of the world's largest multinationals at the time. The large number of U.S. multinationals reflected U.S. economic dominance in the three decades after World War II, while the large number of British multinationals reflected that country's industrial dominance in the early decades of the twentieth century.

By 2008 things had shifted significantly. Some 19 of the world's 100 largest nonfinancial multinationals were now U.S. enterprises; 13 were French; 13, German; 14, British; and 10, Japanese.[39] Although the 1973 data are not strictly comparable with the later data, they illustrate the trend (the 1973 figures are based on the largest 260 firms, whereas the later figures are based on the largest 100 multinationals). The globalization of the world economy has resulted in a relative decline in the dominance of U.S. firms in the global marketplace.

According to UN data, the ranks of the world's largest 100 multinationals are still dominated by firms from developed economies.[40] However, seven firms from developing economies had entered the UN's list of the 100 largest multinationals by 2008. The largest was Hutchison Whampoa of Hong Kong, China, which ranked 22.[41] Firms from developing nations can be expected to emerge as important competitors in global markets, further shifting the axis of the world economy away from North America and Western Europe and threatening the long dominance of Western companies. One such rising competitor, Hisense, one of China's premier manufacturers of consumer appliances and telecommunications equipment, is profiled in the accompanying Management Focus.

The Rise of Mini-Multinationals

Another trend in international business has been the growth of medium-size and small multinationals (mini-multinationals).[43] When people think of international businesses, they tend to think of firms such as Exxon, General Motors, Ford, Fuji, Kodak, Matsushita, Procter & Gamble, Sony, and Unilever—large, complex multinational corporations with operations that span the globe. Although most international trade and investment is still conducted by large firms, many medium-size and small businesses are becoming increasingly involved in international trade and investment. The rise of the Internet is lowering the barriers that small firms face in building international sales.

Consider Lubricating Systems, Inc., of Kent, Washington. Lubricating Systems, which manufactures lubricating fluids for machine tools, employs 25 people and generates sales of

MANAGEMENT FOCUS

China's Hisense—An Emerging Multinational

Hisense is rapidly emerging as one of China's leading multinationals. Like many other Chinese corporations, Hisense traces its origins back to a state-owned manufacturer, in this case Qingdao No. 2 Radio Factory, which was established in 1969 with just 10 employees. In the 1970s the state-owned factory diversified into the manufacture of TV sets, and by the 1980s it was one of China's leading manufacturers of color TVs, making sets designed by Matsushita under license. In 1992, a 35-year-old engineer named Zhou Houjian was appointed head of the enterprise. In 1994 the shackles of state ownership were relaxed when the Hisense Company Ltd. was established with Zhou as CEO (he is now chairman of the board).

Under Zhou's leadership, Hisense entered a period of rapid growth, product diversification, and global expansion. By 2010 the company had sales of more than $7 billion and had emerged as one of China's premier makers of TV sets (with a 12 percent share of the domestic market), air conditioners, refrigerators, personal computers, and telecommunications equipment. Hisense sold around 10 million TV sets, 3 million air conditioners, 4 million CDMA wireless phones, 6 million refrigerators, and 1 million personal computers. International sales accounted for over $500 million, or more than 15 percent of total revenue. The company had established overseas manufacturing subsidiaries in Algeria, Hungary, Iran, Pakistan, and South Africa, and was growing rapidly in developing markets where it was taking share away from long-established consumer electronics and appliance makers.

Hisense's ambitions are grand. It seeks to become a global enterprise with a world-class consumer brand. Although it is without question a low-cost manufacturer, Hisense believes its core strength is in rapid product innovation. The company believes that the only way to gain leadership in the highly competitive markets in which it competes is to continuously launch advanced, high-quality, and competitively priced products.

To this end, Hisense established its first R&D center in China in the mid-1990s. This was followed by a South African R&D center in 1997 and a European R&D center in 2007. The company also has plans for an R&D center in the United States. By 2008 these R&D centers filed for more than 600 patents.

Hisense's technological prowess is evident in its digital TV business. It introduced set-top boxes in 1999, making it possible to browse the Internet from a TV. In 2002, Hisense introduced its first interactive digital TV set, and in 2005 it developed China's first core digital processing chip for digital TVs, breaking the country's reliance on foreign chip makers for this core technology. In 2006, Hisense launched an innovative line of multimedia TV sets that integrated digital high-definition technology, network technology, and flat panel displays.[42]

$6.5 million. It's hardly a large, complex multinational, yet more than $2 million of the company's sales are generated by exports to a score of countries, including Japan, Israel, and the United Arab Emirates. Lubricating Systems also has set up a joint venture with a German company to serve the European market.[44] Consider also Lixi, Inc., a small U.S. manufacturer of industrial X-ray equipment; 70 percent of Lixi's $4.5 million in revenues comes from exports to Japan.[45] Or take G. W. Barth, a manufacturer of cocoa-bean roasting machinery based in Ludwigsburg, Germany. Employing just 65 people, this small company has captured 70 percent of the global market for cocoa-bean roasting machines.[46] International business is conducted not just by large firms but also by medium-size and small enterprises.

THE CHANGING WORLD ORDER

Between 1989 and 1991 a series of democratic revolutions swept the Communist world. For reasons that are explored in more detail in Chapter 3, in country after country throughout Eastern Europe and eventually in the Soviet Union itself, Communist Party governments collapsed. The Soviet Union receded into history, having been replaced by 15 independent republics. Czechoslovakia divided itself into two states, while Yugoslavia dissolved into a bloody civil war, now thankfully over, among its five successor states.

Many of the former Communist nations of Europe and Asia seem to share a commitment to democratic politics and free market economics. For half a century, these countries were essentially closed to Western international businesses. Now they present a host of export and investment opportunities. Just how this will play out over the next 10 to 20 years is difficult to say. The economies of many of the former Communist states are still relatively undeveloped, and their continued commitment to democracy and market-based economic systems cannot be taken for granted. Disturbing signs of growing unrest and totalitarian tendencies continue to be seen in several Eastern European and Central Asian states, including Russia, which has shown signs of shifting back toward greater state involvement in economic activity and authoritarian government.[47] Thus, the risks involved in doing business in such countries are high, but so may be the returns.

In addition to these changes, quieter revolutions have been occurring in China, other states in Southeast Asia, and Latin America. Their implications for international businesses may be just as profound as the collapse of communism in Eastern Europe. China suppressed its own pro-democracy movement in the bloody Tiananmen Square massacre of 1989. Despite this, China continues to move progressively toward greater free market reforms. If what is occurring in China continues for two more decades, China may move from Third World to industrial superpower status even more rapidly than Japan did. If China's gross domestic product (GDP) per capita grows by an average of 6 to 7 percent, which is slower than the 8 percent growth rate achieved during the past decade, then by 2020 this nation of 1.273 billion people could boast an average income per capita of about $13,000, roughly equivalent to that of Spain's today.

The potential consequences for international business are enormous. On the one hand, China represents a huge and largely untapped market. Reflecting this, between 1983 and 2010, annual foreign direct investment in China increased from less than $2 billion to $100 billion annually. On the other hand, China's new firms are proving to be very capable competitors, and they could take global market share away from Western and Japanese enterprises (for example, see the Management Focus about Hisense). Thus, the changes in China are creating both opportunities and threats for established international businesses.

As for Latin America, both democracy and free market reforms have been evident there too. For decades, most Latin American countries were ruled by dictators, many of whom seemed to view Western international businesses as instruments of imperialist domination. Accordingly, they restricted direct investment by foreign firms. In addition, the poorly managed economies of Latin America were characterized by low growth, high debt, and hyperinflation—all of which discouraged investment by international businesses. In the past two decades much of this has changed. Throughout most of Latin America, debt and inflation are down, governments have sold state-owned enterprises to private investors, foreign investment is welcomed, and the region's economies have expanded. Brazil, Mexico, and Chile have led the way. These changes have increased the attractiveness of Latin America, both as a market for exports and as a site for foreign direct investment. At the same time, given the long history of economic mismanagement in Latin America, there is no guarantee that these favorable trends will continue. Indeed, Bolivia, Ecuador, and most notably Venezuela have seen shifts back toward greater state involvement in industry in the past few years, and foreign investment is now less welcome than it was during the 1990s. In these nations, the government has seized control of oil and gas fields from foreign investors and has limited the rights of foreign energy companies to extract oil and gas from their nations. Thus, as in the case of Eastern Europe, substantial opportunities are accompanied by substantial risks.

THE GLOBAL ECONOMY OF THE TWENTY-FIRST CENTURY

As discussed, the past quarter century has seen rapid changes in the global economy. Barriers to the free flow of goods, services, and capital have been coming down. The volume of cross-border trade and investment has been growing more rapidly than global output,

indicating that national economies are becoming more closely integrated into a single, interdependent, global economic system. As their economies advance, more nations are joining the ranks of the developed world. A generation ago, South Korea and Taiwan were viewed as second-tier developing nations. Now they boast large economies, and their firms are major players in many global industries, from shipbuilding and steel to electronics and chemicals. The move toward a global economy has been further strengthened by the widespread adoption of liberal economic policies by countries that had firmly opposed them for two generations or more. Thus, in keeping with the normative prescriptions of liberal economic ideology, in country after country we have seen state-owned businesses privatized, widespread deregulation adopted, markets opened to more competition, and commitment increased to removing barriers to cross-border trade and investment. This suggests that over the next few decades, countries such as the Czech Republic, Mexico, Poland, Brazil, China, India, and South Africa may build powerful market-oriented economies. In short, current trends indicate the world is moving toward an economic system that is more favorable for international business.

But it is always hazardous to use established trends to predict the future. The world may be moving toward a more global economic system, but globalization is not inevitable. Countries may pull back from the recent commitment to liberal economic ideology if their experiences do not match their expectations. There are clear signs, for example, of a retreat from liberal economic ideology in Russia. If Russia's hesitation were to become more permanent and widespread, the liberal vision of a more prosperous global economy based on free market principles might not occur as quickly as many hope. Clearly, this would be a tougher world for international businesses.

Also, greater globalization brings with it risks of its own. This was starkly demonstrated in 1997 and 1998 when a financial crisis in Thailand spread first to other East Asian nations and then to Russia and Brazil. Ultimately, the crisis threatened to plunge the economies of the developed world, including the United States, into a recession. We explore the causes and consequences of this and other similar global financial crises in Chapter 10. Even from a purely economic perspective, globalization is not all good. The opportunities for doing business in a global economy may be significantly enhanced, but as we saw in 1997–1998, the risks associated with global financial contagion are also greater. Indeed, during 2008–2009 a crisis that started in the financial sector of America, where banks had been too liberal in their lending policies to homeowners, swept around the world and plunged the global economy into its deepest recession since the early 1980s, illustrating once more that in an interconnected world a severe crisis in one region can impact the entire globe. Still, as explained later in this book, firms can exploit the opportunities associated with globalization, while at the same time reducing the risks through appropriate hedging strategies.

LO4 The Globalization Debate

Is the shift toward a more integrated and interdependent global economy a good thing? Many influential economists, politicians, and business leaders seem to think so.[48] They argue that falling barriers to international trade and investment are the twin engines driving the global economy toward greater prosperity. They say increased international trade and cross-border investment will result in lower prices for goods and services. They believe that globalization stimulates economic growth, raises the incomes of consumers, and helps to create jobs in all countries that participate in the global trading system. The arguments of those who support globalization are covered in detail in Chapters 6, 7, and 8. As we shall see, there are good theoretical reasons for believing that declining barriers to international trade and investment do stimulate economic growth, create jobs, and raise income levels. As described in Chapters 7 and 8, empirical evidence lends support to the predictions of this theory. However, despite the existence of a compelling body of theory and evidence, globalization has its critics.[49] Some of these critics have become

increasingly vocal and active, taking to the streets to demonstrate their opposition to globalization. Here we look at the nature of protests against globalization and briefly review the main themes of the debate concerning the merits of globalization. In later chapters we elaborate on many of the points mentioned below.

ANTIGLOBALIZATION PROTESTS

Demonstrations against globalization date to December 1999, when more than 40,000 protesters blocked the streets of Seattle in an attempt to shut down a World Trade Organization meeting being held in the city. The demonstrators were protesting against a wide range of issues, including job losses in industries under attack from foreign competitors, downward pressure on the wage rates of unskilled workers, environmental degradation, and the cultural imperialism of global media and multinational enterprises, which was seen as being dominated by what some protesters called the "culturally impoverished" interests and values of the United States. All of these ills, the demonstrators claimed, could be laid at the feet of globalization. The World Trade Organization was meeting to try to launch a new round of talks to cut barriers to cross-border trade and investment. As such, it was seen as a promoter of globalization and a target for the antiglobalization protesters. The protests turned violent, transforming the normally placid streets of Seattle into a running battle between "anarchists" and Seattle's bemused and poorly prepared police department. Pictures of brick-throwing protesters and armored police wielding their batons were duly recorded by the global media, which then circulated the images around the world. Meanwhile, the WTO meeting failed to reach agreement, and although the protests outside the meeting halls had little to do with that failure, the impression took hold that the demonstrators had succeeded in derailing the meetings.

Emboldened by the experience in Seattle, antiglobalization protesters now often turn up at major meetings of global institutions. Smaller scale protests have occurred in several countries, such as France, where antiglobalization activists destroyed a McDonald's restaurant in August 1999 to protest the impoverishment of French culture by American imperialism (see the Country Focus, "Protesting Globalization in France," for details). While violent protests may give the antiglobalization effort a bad name, it is clear from the scale of the demonstrations that support for the cause goes beyond a core of anarchists. Large segments of the population in many countries believe that globalization has detrimental effects on living standards and the environment, and the media have often



Demonstrators at the WTO meeting in Seattle in 1999 began looting and rioting in the city's downtown area.

Protesting Globalization in France

One night in August 1999, 10 men under the leadership of local sheep farmer and rural activist Jose Bove crept into the town of Millau in central France and vandalized a McDonald's restaurant under construction, causing an estimated $150,000 in damage. These were no ordinary vandals, however, at least according to their supporters, for the "symbolic dismantling" of the McDonald's outlet had noble aims, or so it was claimed. The attack was initially presented as a protest against unfair American trade policies. The European Union had banned imports of hormone-treated beef from the United States, primarily because of fears that it might lead to health problems (although EU scientists had concluded there was no evidence of this). After a careful review, the World Trade Organization stated the EU ban was not allowed under trading rules that the EU and United States were party to, and that the EU would have to lift it or face retaliation. The EU refused to comply, so the U.S. government imposed a 100 percent tariff on imports of certain EU products, including French staples such as foie gras, mustard, and Roquefort cheese. On farms near Millau, Bove and others raised sheep whose milk was used to make Roquefort. They felt incensed by the American tariff and decided to vent their frustrations on McDonald's.

Bove and his compatriots were arrested and charged. They quickly became a focus of the antiglobalization movement in France that was protesting everything from a loss of national sovereignty and "unfair" trade policies that were trying to force hormone-treated beef on French consumers, to the invasion of French culture by alien American values, so aptly symbolized by McDonald's. Lionel Jospin, France's prime minister, called the cause of Jose Bove "just." Allowed to remain free pending his trial, Bove traveled to Seattle in December to protest against the World Trade Organization, where he was feted as a hero of the antiglobalization movement. In France, Bove's July 2000 trial drew some 40,000 supporters to the small town of Millau, where they camped outside the courthouse and waited for the verdict. Bove was found guilty and sentenced to three months in jail, far less than the maximum possible sentence of five years. His supporters wore T-shirts claiming, "The world is not merchandise, and neither am I."

About the same time in the Languedoc region of France, California winemaker Robert Mondavi had reached agreement with the mayor and council of the village of Aniane and regional authorities to turn 125 acres of wooded hillside belonging to the village into a vineyard. Mondavi planned to invest $7 million in the project and hoped to produce top-quality wine that would sell in Europe and the United States for $60 a bottle. However, local environmentalists objected to the plan, which they claimed would destroy the area's unique ecological heritage. Jose Bove, basking in sudden fame, offered his support to the opponents, and the protests started. In May 2001, the Socialist mayor who had approved the project was defeated in local elections in which the Mondavi project had become the major issue. He was replaced by a Communist, Manuel Diaz, who denounced the project as a capitalist plot designed to enrich wealthy U.S. shareholders at the cost of his villagers and the environment. Following Diaz's victory, Mondavi announced he would pull out of the project. A spokesman noted, "It's a huge waste, but there are clearly personal and political interests at play here that go way beyond us."

So are the French opposed to foreign investment? The experience of McDonald's and Mondavi seems to suggest so, as does the associated news coverage, but look closer and a different reality seems to emerge. McDonald's has more than 800 restaurants in France and continues to do very well there. In fact, France is one of the most profitable markets for McDonald's. France has long been one of the most favored locations for inward foreign direct investment, receiving over $450 billion of foreign investment between 2006 and 2009, more than any other European nation with the exception of Britain. American companies have always accounted for a significant percentage of this investment. Moreover, French enterprises have also been significant foreign investors; some 1,100 French multinationals account for about 8 percent of the global stock of foreign direct investment.[50]

fed on this fear. For example, former CNN news anchor Lou Dobbs ran TV shows that were highly critical of the trend by American companies to take advantage of globalization and "export jobs" overseas. As the world slipped into a recession in 2008, Dobbs stepped up his antiglobalization rhetoric (Dobbs left CNN in 2009).

Both theory and evidence suggest that many of these fears are exaggerated; both politicians and businesspeople need to do more to counter these fears. Many protests against globalization are tapping into a general sense of loss at the passing of a world in which barriers of time and distance, and vast differences in economic institutions, political institutions, and the level of development of different nations produced a world rich in the diversity of human cultures. However, while the rich citizens of the developed world may have the luxury of mourning the fact that they can now see McDonald's restaurants and Starbucks coffeehouses on their vacations to exotic locations such as Thailand, fewer complaints are heard from the citizens of those countries, who welcome the higher living standards that progress brings.

GLOBALIZATION, JOBS, AND INCOME

One concern frequently voiced by globalization opponents is that falling barriers to international trade destroy manufacturing jobs in wealthy advanced economies such as the United States and Western Europe. The critics argue that falling trade barriers allow firms to move manufacturing activities to countries where wage rates are much lower.[51] Indeed, due to the entry of China, India, and states from Eastern Europe into the global trading system, along with global population growth, estimates suggest that the pool of global labor may have quadrupled between 1985 and 2005, with most of the increase occurring after 1990.[52] Other things being equal, one might conclude that this enormous expansion in the global labor force, when coupled with expanding international trade, would have depressed wages in developed nations.

This fear is supported by anecdotes. For example, D. L. Bartlett and J. B. Steele, two journalists for the *Philadelphia Inquirer* who gained notoriety for their attacks on free trade, cite the case of Harwood Industries, a U.S. clothing manufacturer that closed its U.S. operations, where it paid workers $9 per hour, and shifted manufacturing to Honduras, where textile workers receive 48 cents per hour.[53] Because of moves such as this, argue Bartlett and Steele, the wage rates of poorer Americans have fallen significantly over the past quarter of a century.

In the past few years, the same fears have been applied to services, which have increasingly been outsourced to nations with lower labor costs. The popular feeling is that when corporations such as Dell, IBM, or Citigroup outsource service activities to lower-cost foreign suppliers—as all three have done—they are "exporting jobs" to low-wage nations and contributing to higher unemployment and lower living standards in their home nations (in this case, the United States). Some lawmakers in the United States have responded by calling for legal barriers to job outsourcing.

Supporters of globalization reply that critics of these trends miss the essential point about free trade—the benefits outweigh the costs.[54] They argue that free trade will result in countries specializing in the production of those goods and services that they can produce most efficiently, while importing goods and services that they cannot produce as efficiently. When a country embraces free trade, there is always some dislocation—lost textile jobs at Harwood Industries, or lost call center jobs at Dell—but the whole economy is better off as a result. According to this view, it makes little sense for the United States to produce textiles at home when they can be produced at a lower cost in Honduras or China (which, unlike Honduras, is a major source of U.S. textile imports). Importing textiles from China leads to lower prices for clothes in the United States, which enables consumers to spend more of their money on other items. At the same time, the increased income generated in China from textile exports increases income levels in that country, which helps the Chinese to purchase more products produced in the United States, such as pharmaceuticals from Amgen, Boeing jets, Intel-based computers, Microsoft software, and Cisco routers.

The same argument can be made to support the outsourcing of services to low-wage countries. By outsourcing its customer service call centers to India, Dell can reduce its cost structure, and thereby its prices for PCs. U.S. consumers benefit from this development. As prices for PCs fall, Americans can spend more of their money on other goods and services. Moreover, the increase in income levels in India allows Indians to purchase more U.S. goods and services, which helps to create jobs in the United States. In this manner, supporters of globalization argue that free trade benefits *all* countries that adhere to a free trade regime.

If the critics of globalization are correct, three things must be shown. First, the share of national income received by labor, as opposed to the share received by the owners of capital (e.g., stockholders and bondholders), should have declined in advanced nations as a result of downward pressure on wage rates. Second, even though labor's share of the economic pie may have declined, this does not mean lower living standards if the size of the total pie has increased sufficiently to offset the decline in labor's share; in other words, if economic growth and rising living standards in advanced economies have offset declines in labor's share (this is the position argued by supporters of globalization). Third, the decline in labor's share of national income must be due to moving production to low-wage countries, as opposed to improvement in production technology and productivity.

Several studies shed light on these issues.[55] First, the data suggest that over the past two decades the share of labor in national income has declined. The decline in share is much more pronounced in Europe and Japan (about 10 percentage points) than in the United States and the UK (where it is 3 to 4 percentage points). However, detailed analysis suggests the share of national income enjoyed by *skilled labor* has actually *increased*, suggesting that the fall in labor's share has been due to a fall in the share taken by *unskilled labor*. A study by the IMF suggested the earnings gap between workers in skilled and unskilled sectors has widened by 25 percent over the past two decades.[56] The average income level of the richest 10 percent of the population in developed economies was nine times that of the poorest 10 percent, according to 2010 data. The ratio in the United States was among the highest, with the top 10 percent earning 14 times as much as the bottom 10 percent.[57] These figures strongly suggest that unskilled labor in developed nations has seen its share of national income decline over the past two decades.

However, this does not mean that the *living standards* of unskilled workers in developed nations have declined. It is possible that economic growth in developed nations has offset the fall in the share of national income enjoyed by unskilled workers, raising their living standards. Evidence suggests that real labor compensation has expanded in most developed nations since the 1980s, including the United States. Several studies by the Organization for Economic Cooperation and Development, whose members include the 34 richest economies in the world, conclude that while the gap between the poorest and richest segments of society in OECD countries has widened, in *most* countries real income levels have increased for all, including the poorest segment. In a study published in 2011, the OECD found that between 1985 and 2008 real household income (adjusted for inflation) increased by 1.7 percent annually among its member states. The real income level of the poorest 10 percent of the population increased at 1.4 percent on average, while that of the richest 10 precent increased by 2 percent annually (i.e., while everyone got richer, the gap between the most affluent and the poorest sectors of society widened). The differential in growth rates was more extreme in the United States than most other countries. The study found that the real income of the poorest 10 percent of the population grew by just 0.5 percent a year in the United States between 1985 and 2008, while that of the richest 10 percent grew by 1.9 percent annually.[58]

As noted earlier, globalization critics argue that the decline in unskilled wage rates is due to the migration of low-wage manufacturing jobs offshore and a corresponding reduction in demand for unskilled workers. However, supporters of globalization see a more

complex picture. They maintain that the weak growth rate in real wage rates for unskilled workers owes far more to a technology-induced shift within advanced economies away from jobs where the only qualification was a willingness to turn up for work every day and toward jobs that require significant education and skills. They point out that many advanced economies report a shortage of highly skilled workers and an excess supply of unskilled workers. Thus, growing income inequality is a result of the wages for skilled workers being bid up by the labor market and the wages for unskilled workers being discounted. In fact, evidence suggests that technological change has had a bigger impact than globalization on the declining share of national income enjoyed by labor.[59] This suggests that a solution to the problem of slow real income growth among the unskilled is to be found not in limiting free trade and globalization, but in increasing society's investment in education to reduce the supply of unskilled workers.[60]

Finally, it is worth noting that the wage gap between developing and developed nations is closing as developing nations experience rapid economic growth. For example, one estimate suggests that wages in China will approach Western levels in about 30 years.[61] To the extent that this is the case, any migration of unskilled jobs to low-wage countries is a temporary phenomenon representing a structural adjustment on the way to a more tightly integrated global economy.

GLOBALIZATION, LABOR POLICIES, AND THE ENVIRONMENT

A second source of concern is that free trade encourages firms from advanced nations to move manufacturing facilities to less developed countries that lack adequate regulations to protect labor and the environment from abuse by the unscrupulous.[62] Globalization critics often argue that adhering to labor and environmental regulations significantly increases the costs of manufacturing enterprises and puts them at a competitive disadvantage in the global marketplace vis-à-vis firms based in developing nations that do not have to comply with such regulations. Firms deal with this cost disadvantage, the theory goes, by moving their production facilities to nations that do not have such burdensome regulations or that fail to enforce the regulations they have.

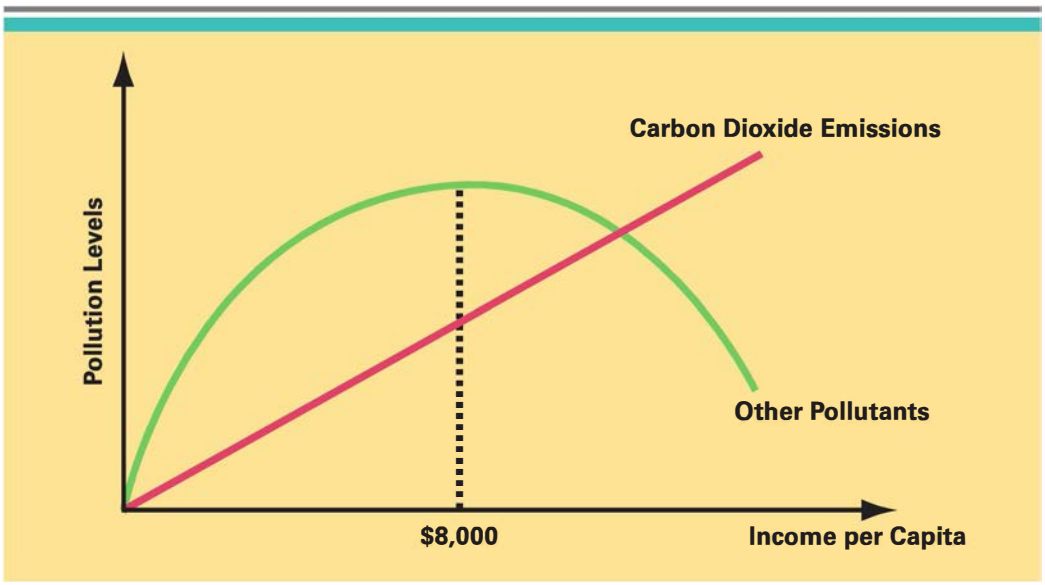
If this were the case, one might expect free trade to lead to an increase in pollution and result in firms from advanced nations exploiting the labor of less developed nations.[63] This argument was used repeatedly by those who opposed the 1994 formation of the North American Free Trade Agreement (NAFTA) between Canada, Mexico, and the United States. They painted a picture of U.S. manufacturing firms moving to Mexico in droves so that they would be free to pollute the environment, employ child labor, and ignore workplace safety and health issues, all in the name of higher profits.[64]

Supporters of free trade and greater globalization express doubts about this scenario. They argue that tougher environmental regulations and stricter labor standards go hand in hand with economic progress.[65] In general, as countries get richer, they enact tougher environmental and labor regulations.[66] Because free trade enables developing countries to increase their economic growth rates and become richer, this should lead to tougher environmental and labor laws. In this view, the critics of free trade have got it backward—free trade does not lead to more pollution and labor exploitation, it leads to less. By creating wealth and incentives for enterprises to produce technological innovations, the free market system and free trade could make it easier for the world to cope with pollution and population growth. Indeed, while pollution levels are rising in the world's poorer countries, they have been falling in developed nations. In the United States, for example, the concentration of carbon monoxide and sulphur dioxide pollutants in the atmosphere decreased by 60 percent between 1978 and 1997, while lead concentrations decreased by 98 percent—and these reductions have occurred against a background of sustained economic expansion.[67]

A number of econometric studies have found consistent evidence of a hump-shaped relationship between income levels and pollution levels (see Figure 1.5).[68] As

FIGURE 1.5

Income Levels and Environmental Pollution



an economy grows and income levels rise, initially pollution levels also rise. However, past some point, rising income levels lead to demands for greater environmental protection, and pollution levels then fall. A seminal study by Grossman and Krueger found that the turning point generally occurred before per capita income levels reached $8,000.[69]

While the hump-shaped relationship depicted in Figure 1.5 seems to hold across a wide range of pollutants—from sulphur dioxide to lead concentrations and water quality—carbon dioxide emissions are an important exception, rising steadily with higher income levels. Given that increased atmospheric carbon dioxide concentrations are a cause of global warming, this should be of serious concern. The solution to the problem, however, is probably not to roll back the trade liberalization efforts that have fostered economic growth and globalization, but to get the nations of the world to agree to tougher standards on limiting carbon emissions. Although UN-sponsored talks have had this as a central aim since the 1992 Earth Summit in Rio de Janeiro, there has been little success in moving toward the ambitious goals for reducing carbon emissions laid down in the Earth Summit and subsequent talks in Kyoto, Japan, in 1997 and in Copenhagen in 2009. In part this is because the largest emitters of carbon dioxide, the United States and China, have failed to reach agreements about how to proceed. China, a country whose carbon emissions are increasing at an alarming rate, has so far shown little appetite to adopt tighter pollution controls. As for the United States, political divisions in Congress have made it difficult for even a progressive administration such as that of Barack Obama to move forward with tight legislation on climate change.

Notwithstanding this, supporters of free trade point out that it is possible to tie free trade agreements to the implementation of tougher environmental and labor laws in less developed countries. NAFTA, for example, was passed only after side agreements had been negotiated that committed Mexico to tougher enforcement of environmental protection regulations. Thus, supporters of free trade argue that factories based in Mexico are now cleaner than they would have been without the passage of NAFTA.[70]

They also argue that business firms are not the amoral organizations that critics suggest. While there may be some rotten apples, most business enterprises are staffed by managers who are committed to behave in an ethical manner and would be unlikely to move production offshore just so they could pump more pollution into the atmosphere or exploit labor. Furthermore, the relationship between pollution, labor exploitation, and production costs may not be that suggested by critics. In general, a well-treated labor

force is productive, and it is productivity rather than base wage rates that often has the greatest influence on costs. The vision of greedy managers who shift production to low-wage countries to exploit their labor force may be misplaced.

GLOBALIZATION AND NATIONAL SOVEREIGNTY

Another concern voiced by critics of globalization is that today's increasingly interdependent global economy shifts economic power away from national governments and toward supranational organizations such as the World Trade Organization, the European Union, and the United Nations. As perceived by critics, unelected bureaucrats now impose policies on the democratically elected governments of nation-states, thereby undermining the sovereignty of those states and limiting the nation's ability to control its own destiny.[71]

The World Trade Organization is a favorite target of those who attack the headlong rush toward a global economy. As noted earlier, the WTO was founded in 1994 to police the world trading system established by the General Agreement on Tariffs and Trade. The WTO arbitrates trade disputes between the 154 states that are signatories to the GATT. The arbitration panel can issue a ruling instructing a member state to change trade policies that violate GATT regulations. If the violator refuses to comply with the ruling, the WTO allows other states to impose appropriate trade sanctions on the transgressor. As a result, according to one prominent critic, U.S. environmentalist, consumer rights advocate, and sometime presidential candidate Ralph Nader:

> Under the new system, many decisions that affect billions of people are no longer made by local or national governments but instead, if challenged by any WTO member nation, would be deferred to a group of unelected bureaucrats sitting behind closed doors in Geneva (which is where the headquarters of the WTO are located). The bureaucrats can decide whether or not people in California can prevent the destruction of the last virgin forests or determine if carcinogenic pesticides can be banned from their foods; or whether European countries have the right to ban dangerous biotech hormones in meat. . . . At risk is the very basis of democracy and accountable decision making.[72]

In contrast to Nader, many economists and politicians maintain that the power of supranational organizations such as the WTO is limited to what nation-states collectively agree to grant. They argue that bodies such as the United Nations and the WTO exist to serve the collective interests of member states, not to subvert those interests. Supporters of supranational organizations point out that the power of these bodies rests largely on their ability to persuade member states to follow a certain action. If these bodies fail to serve the collective interests of member states, those states will withdraw their support and the supranational organization will quickly collapse. In this view, real power still resides with individual nation-states, not supranational organizations.

GLOBALIZATION AND THE WORLD'S POOR

Critics of globalization argue that despite the supposed benefits associated with free trade and investment, over the past hundred years or so the gap between the rich and poor nations of the world has gotten wider. In 1870, the average income per capita in the world's 17 richest nations was 2.4 times that of all other countries. In 1990, the same group was 4.5 times as rich as the rest.[73] While recent history has shown that some of the world's poorer nations are capable of rapid periods of economic growth—witness the transformation that has occurred in some Southeast Asian nations such as South Korea, Thailand, and Malaysia—there appear to be strong forces for stagnation among the world's poorest nations. A quarter of the countries with a GDP per capita of less than $1,000 in 1960 had growth rates of less than zero from 1960 to 1995, and a third had growth rates of less than 0.05 percent.[74] Critics argue that if globalization is such a positive development, this divergence between the rich and poor should not have occurred.

Although the reasons for economic stagnation vary, several factors stand out, none of which have anything to do with free trade or globalization.[75] Many of the world's poorest countries have suffered from totalitarian governments, economic policies that destroyed wealth rather than facilitated its creation, endemic corruption, scant protection for property rights, and war. Such factors help explain why countries such as Afghanistan, Cambodia, Cuba, Haiti, Iraq, Libya, Nigeria, Sudan, Vietnam, and Zaire have failed to improve the economic lot of their citizens during recent decades. A complicating factor is the rapidly expanding populations in many of these countries. Without a major change in government, population growth may exacerbate their problems. Promoters of free trade argue that the best way for these countries to improve their lot is to lower their barriers to free trade and investment and to implement economic policies based on free market economics.[76]

Many of the world's poorer nations are being held back by large debt burdens. Of particular concern are the 40 or so "highly indebted poorer countries" (HIPCs), which are home to some 700 million people. Among these countries, the average government debt burden has been has high as 85 percent of the value of the economy, as measured by gross domestic product, and the annual costs of serving government debt consumed 15 percent of the country's export earnings.[77] Servicing such a heavy debt load leaves the governments of these countries with little left to invest in important public infrastructure projects, such as education, health care, roads, and power. The result is the HIPCs are trapped in a cycle of poverty and debt that inhibits economic development. Free trade alone, some argue, is a necessary but not sufficient prerequisite to help these countries bootstrap themselves out of poverty. Instead, large-scale debt relief is needed for the world's poorest nations to give them the opportunity to restructure their economies and start the long climb toward prosperity. Supporters of debt relief also argue that new democratic governments in poor nations should not be forced to honor debts that were incurred and mismanaged long ago by their corrupt and dictatorial predecessors.

In the late 1990s, a debt relief movement began to gain ground among the political establishment in the world's richer nations.[78] Fueled by high-profile endorsements from Irish rock star Bono (who has been a tireless and increasingly effective advocate for debt relief), the Dalai Lama, and influential Harvard economist Jeffrey Sachs, the debt relief movement was instrumental in persuading the United States to enact legislation in 2000 that provided $435 million in debt relief for HIPCs. More important perhaps, the United States also backed an IMF plan to sell some of its gold reserves and use the proceeds to help with debt relief. The IMF and World Bank have now picked up the banner and have embarked on a systematic debt relief program.



U2's Bono has actively lobbied to have the unpayable debt of poor countries written off.

For such a program to have a lasting effect, however, debt relief must be matched by wise investment in public projects that boost economic growth (such as education) and by the adoption of economic policies that facilitate investment and trade. The rich nations of the world also can help by reducing barriers to the importation of products from the world's poorer nations, particularly tariffs on imports of agricultural products and textiles. High tariff barriers and other impediments to trade make it difficult for poor countries to export more of their agricultural production. The World Trade Organization has estimated that if the developed nations of the world eradicated subsidies to their agricultural producers and removed tariff barriers to trade in agriculture this would raise global economic welfare by $128 billion, with $30 billion of that going to developing nations, many of which are highly indebted. The faster growth associated with expanded trade in agriculture could reduce the number of people living in poverty by as much as 13 percent by 2015, according to the WTO.[79]

Managing in the Global Marketplace LO5

Much of this book is concerned with the challenges of managing in an international business. An **international business** is any firm that engages in international trade or investment. A firm does not have to become a multinational enterprise, investing directly in operations in other countries, to engage in international business, although multinational enterprises are international businesses. All a firm has to do is export or import products from other countries. As the world shifts toward a truly integrated global economy, more firms, both large and small, are becoming international businesses. What does this shift toward a global economy mean for managers within an international business?

As their organizations increasingly engage in cross-border trade and investment, managers need to recognize that the task of managing an international business differs from that of managing a purely domestic business in many ways. At the most fundamental level, the differences arise from the simple fact that countries are different. Countries differ in their cultures, political systems, economic systems, legal systems, and levels of economic development. Despite all the talk about the emerging global village, and despite the trend toward globalization of markets and production, as we shall see in this book, many of these differences are very profound and enduring.

Differences between countries require that an international business vary its practices country by country. Marketing a product in Brazil may require a different approach from marketing the product in Germany; managing U.S. workers might require different skills than managing Japanese workers; maintaining close relations with a particular level of government may be very important in Mexico and irrelevant in Great Britain; the business strategy pursued in Canada might not work in South Korea; and so on. Managers in an international business must not only be sensitive to these differences, but they must also adopt the appropriate policies and strategies for coping with them. Much of this book is devoted to explaining the sources of these differences and the methods for successfully coping with them.

A further way in which international business differs from domestic business is the greater complexity of managing an international business. In addition to the problems that arise from the differences between countries, a manager in an international business is confronted with a range of other issues that the manager in a domestic business never confronts. The managers of an international business must decide where in the world to site production activities to minimize costs and to maximize value added. They must decide whether it is ethical to adhere to the lower labor and environmental standards found in many less developed nations. Then they must decide how best to coordinate and control globally dispersed production activities (which, as we shall see later in the book, is not a trivial problem). The managers in an international business also must decide which foreign markets to enter and which to avoid. They must choose the appropriate mode for entering a particular foreign country. Is it best to export its product to the foreign country? Should the firm allow a local company to produce its product under license in that country? Should the firm enter into a joint venture with a local firm to produce its product in that country? Or should the firm set up a wholly owned subsidiary to serve the market in that country? As we shall see, the choice of entry mode is critical because it has major implications for the long-term health of the firm.

Conducting business transactions across national borders requires understanding the rules governing the international trading and investment system. Managers in an international business must also deal with government restrictions on international trade and investment. They must find ways to work within the limits imposed by specific governmental interventions. As this book explains, even though many governments are nominally committed to free trade, they often intervene to regulate cross-border trade and investment. Managers within international businesses must develop strategies and policies for dealing with such interventions.

Cross-border transactions also require that money be converted from the firm's home currency into a foreign currency and vice versa. Because currency exchange rates vary in

response to changing economic conditions, managers in an international business must develop policies for dealing with exchange rate movements. A firm that adopts a wrong policy can lose large amounts of money, whereas one that adopts the right policy can increase the profitability of its international transactions.

In sum, managing an international business is different from managing a purely domestic business for at least four reasons: (1) countries are different, (2) the range of problems confronted by a manager in an international business is wider and the problems themselves more complex than those confronted by a manager in a domestic business, (3) an international business must find ways to work within the limits imposed by government intervention in the international trade and investment system, and (4) international transactions involve converting money into different currencies.

In this book we examine all these issues in depth, paying close attention to the different strategies and policies that managers pursue to deal with the various challenges created when a firm becomes an international business. Chapters 2, 3, and 4 explore how countries differ from each other with regard to their political, economic, legal, and cultural institutions. Chapter 5 takes a detailed look at the ethical issues that arise in international business. Chapters 6 to 9 look at the international trade and investment environment within which international businesses must operate. Chapters 10 to 12 review the international monetary system. These chapters focus on the nature of the foreign exchange market and the emerging global monetary system. Chapters 13 to 15 explore the strategy of international businesses. Chapters 16 to 20 look at the management of various functional operations within an international business, including production, marketing, and human relations. By the time you complete this book, you should have a good grasp of the issues that managers working within international business have to grapple with on a daily basis, and you should be familiar with the range of strategies and operating policies available to compete more effectively in today's rapidly emerging global economy.

CHAPTER SUMMARY

This chapter shows how the world economy is becoming more global and reviews the main drivers of globalization, arguing that they seem to be thrusting nation-states toward a more tightly integrated global economy. It looks at how the nature of international business is changing in response to the changing global economy; discusses concerns raised by rapid globalization; and reviews implications of rapid globalization for individual managers. The chapter made the following points:

1. Over the past three decades, we have witnessed the globalization of markets and production.
2. The globalization of markets implies that national markets are merging into one huge marketplace. However, it is important not to push this view too far.
3. The globalization of production implies that firms are basing individual productive activities at the optimal world locations for the particular activities. As a consequence, it is increasingly irrelevant to talk about American products, Japanese products, or German products, since these are being replaced by "global" products.
4. Two factors seem to underlie the trend toward globalization: declining trade barriers and changes in communication, information, and transportation technologies.
5. Since the end of World War II, barriers to the free flow of goods, services, and capital have been lowered significantly. More than anything else, this has facilitated the trend toward the globalization of production and has enabled firms to view the world as a single market.
6. As a consequence of the globalization of production and markets, in the last decade world trade has grown faster than world output, foreign direct investment has surged, imports have

penetrated more deeply into the world's industrial nations, and competitive pressures have increased in industry after industry.

7. The development of the microprocessor and related developments in communication and information processing technology have helped firms link their worldwide operations into sophisticated information networks. Jet air travel, by shrinking travel time, has also helped to link the worldwide operations of international businesses. These changes have enabled firms to achieve tight coordination of their worldwide operations and to view the world as a single market.
8. In the 1960s, the U.S. economy was dominant in the world, U.S. firms accounted for most of the foreign direct investment in the world economy, U.S. firms dominated the list of large multinationals, and roughly half the world—the centrally planned economies of the Communist world—was closed to Western businesses.
9. By the mid-1990s, the U.S. share of world output had been cut in half, with major shares now being accounted for by Western European and Southeast Asian economies. The U.S. share of worldwide foreign direct investment had also fallen, by about two-thirds. U.S. multinationals were now facing competition from a large number of Japanese and European multinationals. In addition, the emergence of mini-multinationals was noted.
10. One of the most dramatic developments of the past 20 years has been the collapse of communism in Eastern Europe, which has created enormous long-run opportunities for international businesses. In addition, the move toward free market economies in China and Latin America is creating opportunities (and threats) for Western international businesses.
11. The benefits and costs of the emerging global economy are being hotly debated among businesspeople, economists, and politicians. The debate focuses on the impact of globalization on jobs, wages, the environment, working conditions, and national sovereignty.
12. Managing an international business is different from managing a domestic business for at least four reasons: (*i*) countries are different, (*ii*) the range of problems confronted by a manager in an international business is wider and the problems themselves more complex than those confronted by a manager in a domestic business, (*iii*) managers in an international business must find ways to work within the limits imposed by governments' intervention in the international trade and investment system, and (*iv*) international transactions involve converting money into different currencies.

Critical Thinking and Discussion Questions

1. Describe the shifts in the world economy over the past 30 years. What are the implications of these shifts for international businesses based in Great Britain? North America? Hong Kong?
2. "The study of international business is fine if you are going to work in a large multinational enterprise, but it has no relevance for individuals who are going to work in small firms." Evaluate this statement.
3. How have changes in technology contributed to the globalization of markets and production? Would the globalization of production and markets have been possible without these technological changes?
4. "Ultimately, the study of international business is no different from the study of domestic business. Thus, there is no point in having a separate course on international business." Evaluate this statement.
5. How do the Internet and the associated World Wide Web affect international business activity and the globalization of the world economy?
6. If current trends continue, China may be the world's largest economy by 2020. Discuss the possible implications of such a development for (*a*) the world trading system, (*b*) the world monetary system, (*c*) the business strategy of today's European and U.S.-based global corporations, and (*d*) global commodity prices.
7. Reread the Management Focus on Vizio and answer the following questions:
   a. Why is the manufacturing of flat panel TVs migrating to different locations around the world?
   b. Who benefits from the globalization of the flat panel display industry? Who are the losers?

c. What would happen if the U.S. government required that flat panel displays sold in the United States had to also be made in the United States? On balance, would this be a good or a bad thing?

d. What does the example of Vizio tell you about the future of production in an increasingly integrated global economy? What does it tell you about the strategies that enterprises must adopt to thrive in highly competitive global markets?

Research Task globalEDGE globaledge.msu.edu

Globalization

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

Your company has developed a new product that has universal appeal across countries and cultures. In fact, it is expected to achieve high penetration rates in all the countries where it is introduced, regardless of the average income of the local populace. Considering the costs of the product launch, the management team has decided to initially introduce the product only in countries that have a sizable population base. You are required to prepare a preliminary report with the top 10 countries in terms of population size. A member of management has indicated that a resource called the "*World Population Data Sheet*" may be useful for the report. Since growth opportunities are another major concern, the average population growth rates should be listed also for management's consideration.

Exercise 2

You are working for a company that is considering investing in a foreign country. Investing in countries with different traditions is an important element of your company's long-term strategic goals. As such, management has requested a report regarding the attractiveness of alternative countries based on the potential return of FDI. Accordingly, the ranking of the top 25 countries in terms of FDI attractiveness is a crucial ingredient for your report. A colleague mentioned a potentially useful tool called the "*FDI Confidence Index*" which is updated periodically. Find this index and provide additional information regarding how the index is constructed.

CLOSING CASE

The Globalization of Starbucks

Thirty years ago, Starbucks was a single store in Seattle's Pike Place Market selling premium-roasted coffee. Today it is a global roaster and retailer of coffee with some 16,700 stores, 40 percent of which are in 50 countries outside of the United States. Starbucks set out on its current course in the 1980s when the company's director of marketing, Howard Schultz, came back from a trip to Italy enchanted with the Italian coffeehouse experience. Schultz, who later became CEO, persuaded the company's owners to experiment with the coffeehouse format—and the Starbucks experience was born. The strategy was to sell the company's own premium roasted coffee and freshly brewed espresso-style coffee beverages, along with a variety of pastries, coffee accessories, teas, and other products, in a tastefully designed coffeehouse setting. The company focused on selling "a third place experience," rather than just the coffee. The formula led to spectacular success in the United States, where Starbucks went from obscurity to one of the best-known brands in the country in a decade. Thanks to Starbucks, coffee stores became places for relaxation, chatting with friends, reading the newspaper, holding business meetings, or (more recently) browsing the web.

In 1995, with 700 stores across the United States, Starbucks began exploring foreign opportunities. The first target market was Japan. The company established a joint venture with a local retailer, Sazaby Inc. Each company held a 50 percent stake in the venture, Starbucks Coffee of Japan. Starbucks initially invested $10 million in this venture, its first foreign direct investment. The Starbucks format was then licensed to the venture, which was charged with taking over responsibility for growing Starbucks' presence in Japan.

To make sure the Japanese operations replicated the "Starbucks experience" in North America, Starbucks transferred some employees to the Japanese operation. The licensing agreement required all Japanese store managers and employees to attend training classes similar to those given to U.S. employees. The agreement also required that stores adhere to the design parameters

established in the United States. In 2001, the company introduced a stock option plan for all Japanese employees, making it the first company in Japan to do so. Skeptics doubted that Starbucks would be able to replicate its North American success overseas, but by the end of 2009 Starbucks had some 850 stores and a profitable business in Japan.

After Japan, the company embarked on an aggressive foreign investment program. In 1998, it purchased Seattle Coffee, a British coffee chain with 60 retail stores, for $84 million. An American couple, originally from Seattle, had started Seattle Coffee with the intention of establishing a Starbucks-like chain in Britain. In the late 1990s, Starbucks opened stores in Taiwan, China, Singapore, Thailand, New Zealand, South Korea, and Malaysia. In Asia, Starbucks' most common strategy was to license its format to a local operator in return for initial licensing fees and royalties on store revenues. As in Japan, Starbucks insisted on an intensive employee-training program and strict specifications regarding the format and layout of the store.

By 2002, Starbucks was pursuing an aggressive expansion in mainland Europe. As its first entry point, Starbucks chose Switzerland. Drawing on its experience in Asia, the company entered into a joint venture with a Swiss company, Bon Appetit Group, Switzerland's largest food service company. Bon Appetit was to hold a majority stake in the venture, and Starbucks would license its format to the Swiss company using a similar agreement to those it had used successfully in Asia. This was followed by a joint venture in other countries.

As it has grown its global footprint, Starbucks has also embraced ethical sourcing policies and environmental responsibility. Now one of the world's largest buyers of coffee, in 2000 Starbucks started to purchase Fair Trade Certified coffee. The goal was to empower small-scale farmers organized in cooperatives to invest in their farms and communities, to protect the environment, and to develop the business skills necessary to compete in the global marketplace. In short, Starbucks was trying to use its influence to not only change the way people consumed coffee around the world, but also to change the way coffee was produced in a manner that benefited the farmers and the environment. By 2010, some 75 percent of the coffee Starbucks purchased was Fair Trade Certified, and the company has a goal of increasing that to 100 percent by 2015.[80]

Case Discussion Questions

1. Where did the original idea for the Starbucks format come from? What lesson for international business can be drawn from this?
2. What drove Starbucks to start expanding internationally? How is the company creating value for its shareholders by pursuing an international expansion strategy?
3. Why do you think Starbucks decided to enter the Japanese market via a joint venture with a Japanese company? What lesson can you draw from this?
4. Is Starbucks a force for globalization? Explain your answer.
5. When it comes to purchasing coffee beans, Starbucks adheres to a "fair trade" program. What do you think is the difference between fair trade and free trade? How might a fair trade policy benefit Starbucks?

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part one case

The Globalization of Health Care 42

The Globalization of Health Care

It has long been thought that health care is one of the industries least vulnerable to dislocation from globalization. After all, like many service businesses, health care is normally delivered where it is purchased. However, for some activities and procedures, this is now fast changing. The trend began with certain diagnostic procedures, such as MRI scans. The United States has a shortage of radiologists, the doctors who specialize in reading and interpreting diagnostic medical images, including X-rays, CT scans, MRI scans, and ultrasounds. Demand for radiologists has been growing twice as fast as the rate at which medical schools are graduating radiologists with the skills and qualifications required to read medical images. This imbalance between supply and demand means that radiologists are expensive; an American radiologist can earn as much as $400,000 a year. In the early 2000s, an Indian radiologist working at the Massachusetts General Hospital, Dr. Sanjay Saini, found a way to deal with the shortage and expense—send images over the Internet to India, where they could be interpreted by radiologists. This would reduce the workload on America's radiologists and also cut costs. A radiologist in India might earn one-tenth of his or her U.S. counterpart. Plus, because India is on the opposite side of the globe, the images could be interpreted while it was nighttime in the United States and be ready for the attending physician when he or she arrived for work the following morning.

The globalization trend has now spilled over into surgery. In the fall of 2008, for example, Adrienne de Forrest of Colorado had hip surgery in Chennai, India, while Texan David Jones had triple bypass surgery in New Delhi. Both patients were uninsured. De Forrest's surgery cost $8,000, and Jones's cost $16,000 including travel expenses. Had those operations been done in the United States, they would have cost $45,000 and $250,000, respectively. Forrest and Jones are not alone; in 2007 some 750,000 Americans traveled abroad for medical treatment. The consulting company Deloitte is forecasting the numbers to reach 10 million by 2012, which would be worth about $21 billion to those nations where the procedures are performed.

Some might be worried about the quality of medical care in other countries, but medical tourists typically go to new hospitals, most of which are private, where highly skilled physicians treat them, many of whom trained in the United States or Britain. The three largest recipient countries of American patients are Mexico (due to its proximity), India (where 450,000 were treated in 2007), and Singapore (where more than 400,000 were treated in 2007, and where the local medical schools are considered to be among the very best in the world). Costs in these countries generally run from 20 to 35 percent of those in the United States.

A number of factors are driving the globalization trend. First there is the high cost of medical care in the United States, which is the source of the largest number of patients. Then there is the fact that over 45 million Americans are uninsured and many more are "underinsured" and face high copayments for expensive procedures (although recent legislation in the United States should change this over the next five years). Many of these people find it far cheaper to fly abroad to get treatment. Third is the emergence of high-quality private hospital chains in places such as India and Singapore. Fourth, the rising costs of insuring their workforces are starting to persuade some large American companies to look abroad. And finally, some insurance companies are experimenting with payment for foreign treatment at internationally accredited hospitals. In 2008, for example, Aetna, a large insurer, launched a pilot scheme in partnership with Singaporean hospitals. Aetna started to give Americans the option to have procedures costing $20,000 or more in the United States performed in Singapore, where the company reckons that the quality of care is better than at the average American hospital.[1]

Case Discussion Questions

1. What are the facilitating developments that have allowed health care to start globalizing?
2. Who benefits from the globalization of health care? Who are the losers?
3. Are there any risks associated with the globalization of health care? Can these risks be mitigated? How?
4. On balance, do you think that the globalization of health care is a good thing, or not?

Source

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part two Country Differences

2 National Differences in Political Economy

LEARNING OBJECTIVES:

After reading this chapter you will be able to:

- LO1 Understand how the political systems of countries differ.
- LO2 Understand how the economic systems of countries differ.
- LO3 Understand how the legal systems of countries differ.
- LO4 Explain the implications for management practice of national differences in political economy.

The Polish Surprise

As the financial crisis of 2008 and 2009 unfolded, countries across Europe were hit hard. A notable exception was Poland, whose economy grew by 1.5 percent during 2009, while every other economy in the European Union contracted. How did Poland achieve this? The country benefited from sound economic policy, a stable political system, and some luck.

In 1989, Poland elected its first democratic government after more than four decades of Communist rule. Since then, like many other Eastern European countries, Poland has embraced market-based economic policies, opened its markets to international trade and foreign investment, and privatized many state-owned businesses. In 2004 the country joined the European Union, giving it easy access to the large consumer markets of Western Europe. All this helped transform Poland into a major exporter. Exports account for about 40 percent of gross domestic product (in contrast, they account for around 12 percent in the United States). As a consequence, between 1989 and 2010 Poland recorded the highest sustained growth in the region. Real GDP doubled over this period, compared to a 70 percent increase in neighboring Slovakia and 45 percent in the Czech Republic.

Poland's government has also been fiscally conservative, keeping public debt in check, not allowing it to expand during the recession as many other countries did. This led to investor confidence in the country. As a result there was no large outflow of funds during the 2008–2009 economic turmoil. This stands in stark contrast to what happened in the Baltic states and Greece, where investors pulled money out of those economies during 2008 and 2009, driving their currencies down, raising the cost of government debt, and precipitating a full-blown economic crisis that required the IMF and EU to step in with financial assistance.

Poland also got lucky. A tight monetary squeeze in the early 2000s, which was designed to curb inflation



and ease Poland's entry into the European Union, headed off the asset price bubble, particularly surging home prices, that hurt so many other economies around the world. Ironically, the Polish government had been criticized for its tight monetary policy earlier in the decade, but in 2008 and 2009 it served the country well. Moreover, in 2009 Poland benefited from the economic stimulus in neighboring Germany. A scheme to boost demand for German automobile companies by giving cash grants to people who exchanged old cars for new ones (a "cash for clunkers" program) helped Poland because the country has several automobile plants and was selling many cars and components to Germany.

None of this is to say that Poland is a model state. The country still has substantial problems. Migrant workers returning from Western Europe have swelled the ranks of the unemployed. In 2009 unemployment hit 11 percent. The tax system is complex and archaic. A study by the World Bank put the Polish tax system at 151st out of the 183 countries it surveyed. Extensive regulations can still make it difficult to do business in Poland; the World Bank ranked Poland 76th in ease of doing business. Even after 20 years, the transition from a socialist economy to a market-based system is still not complete and many state-owned enterprises remain.

On the other hand, the Polish government has committed itself to changing much of this. Steps are being taken to simplify tax laws, reduce tax rates, and remove bureaucratic hurdles to doing business in the country. An example was the Entrepreneurship Law passed in March 2009, which dramatically reduced the number of health, labor, and tax controls that companies had to comply with, making it much easier to start a business in the country. Also, after a six-year standstill, Poland privatized state-owned enterprises that accounted for 0.6 percent of GDP in 2009, and those accounting for another 2.5 percent of GDP in 2010.[1]

Introduction

International business is much more complicated than domestic business because countries differ in many ways. Countries have different political, economic, and legal systems. They vary significantly in their level of economic development and future economic growth trajectory. Cultural practices can vary dramatically, as can the education and skill level of the population. All these differences can and do have major implications for the practice of international business. They have a profound impact on the benefits, costs, and risks associated with doing business in different countries; the way in which operations in different countries should be managed; and the strategy international firms should pursue in different countries. The main function of this chapter and the next two is to develop an awareness of and appreciation for the significance of country differences in political systems, economic systems, legal systems, economic development, and societal culture. Another function of the three chapters is to describe how the political, economic, legal, and cultural systems of many of the world's nation-states are evolving and to draw out the implications of these changes for the practice of international business.

The opening case illustrates some of the issues covered in this chapter and the next. For decades until 1989 Poland was ruled by a Communist regime and had a centrally planned economy where there was little scope for private enterprises, and where international business had only few opportunities. Over the past two decades all this has changed. Poland is now one of the most dynamic and successful of the old Communist states. Having embraced a democratic political system and market-based economic ideals, the country privatized many state-owned businesses, deregulated its economy, and welcomed foreign direct investment. In 2004, a now vibrant Poland joined the European Union, which helped to further spur the country's export-led growth. A combination of tight monetary policy and restrained government spending put Poland in a strong position to weather the financial crisis that swept around the globe in 2008–2009. Poland was the only EU member to grow during 2009. Today Poland is a strong and stable democracy that offers many opportunities for international businesses. At the same time, the country still has some way to go. It is now reforming its complex tax code and removing burdensome regulations, all of which should help the country to grow and increase its appeal as a place where foreign enterprises can do business.

This chapter focuses on how the political, economic, and legal systems of countries differ. Collectively we refer to these systems as constituting the political economy of a country. We use the term **political economy** to stress that the political, economic, and legal systems of a country are interdependent; they interact and influence each other, and in doing so they affect the level of economic well-being. In Chapter 3, we build on the concepts discussed here to explore in detail how differences in political, economic, and legal systems influence the economic development of a nation-state and its likely future growth trajectory. In Chapter 4 we will look at differences in societal culture, and at how these differences influence the practice of international business. Moreover, as we will see in Chapter 4, societal culture has an influence on the political, economic, and legal systems in a nation, and thus its level of economic well-being. We will also discuss how the converse may also occur—how political, economic, and legal systems may also shape societal culture.

LO1 Political Systems

The political system of a country shapes its economic and legal systems.[2] As such, we need to understand the nature of different political systems before discussing economic and legal systems. By **political system** we mean the system of government in a nation. Political systems can be assessed according to two dimensions. The first is the degree to which they emphasize collectivism as opposed to individualism. The second is the degree to which they are democratic or totalitarian. These dimensions are interrelated; systems that emphasize collectivism tend toward totalitarian, whereas those that place a high value on

individualism tend to be democratic. However, a large gray area exists in the middle. It is possible to have democratic societies that emphasize a mix of collectivism and individualism. Similarly, it is possible to have totalitarian societies that are not collectivist.

COLLECTIVISM AND INDIVIDUALISM

Collectivism refers to a political system that stresses the primacy of collective goals over individual goals.[3] When collectivism is emphasized, the needs of society as a whole are generally viewed as being more important than individual freedoms. In such circumstances, an individual's right to do something may be restricted on the grounds that it runs counter to "the good of society" or to "the common good." Advocacy of collectivism can be traced to the ancient Greek philosopher Plato (427–347 BC), who in *The Republic* argued that individual rights should be sacrificed for the good of the majority and that property should be owned in common. Plato did not equate collectivism with equality; he believed that society should be stratified into classes, with those best suited to rule (which for Plato, naturally, were philosophers and soldiers) administering society for the benefit of all. In modern times, the collectivist mantle has been picked up by socialists.

Socialism

Modern **socialists** trace their intellectual roots to Karl Marx (1818–83), although socialist thought clearly predates Marx (elements of it can be traced to Plato). Marx argued that the few benefit at the expense of the many in a capitalist society where individual freedoms are not restricted. While successful capitalists accumulate considerable wealth, Marx postulated that the wages earned by the majority of workers in a capitalist society would be forced down to subsistence levels. He argued that capitalists expropriate for their own use the value created by workers, while paying workers only subsistence wages in return. According to Marx, the pay of workers does not reflect the full value of their labor. To correct this perceived wrong, Marx advocated state ownership of the basic means of production, distribution, and exchange (i.e., businesses). His logic was that if the state owned the means of production, the state could ensure that workers were fully compensated for their labor. Thus, the idea is to manage state-owned enterprise to benefit society as a whole, rather than individual capitalists.[4]

In the early twentieth century, the socialist ideology split into two broad camps. The **communists** believed that socialism could be achieved only through violent revolution and totalitarian dictatorship, whereas the **social democrats** committed themselves to achieving socialism by democratic means, turning their backs on violent revolution and dictatorship. Both versions of socialism waxed and waned during the twentieth century. The communist version of socialism reached its high point in the late 1970s, when the majority of the world's population lived in communist states. The countries under Communist Party rule at that time included the former Soviet Union; its Eastern European client nations (e.g., Poland, Czechoslovakia, Hungary); China; the Southeast Asian nations of Cambodia, Laos, and Vietnam; various African nations (e.g., Angola and Mozambique); and the Latin American nations of Cuba and Nicaragua. By the mid-1990s, however, communism was in retreat worldwide. The Soviet Union had collapsed and had been replaced by a collection of 15 republics, many of which were at least nominally structured as democracies. Communism was swept out of Eastern Europe by the largely bloodless revolutions of 1989. Although China is still nominally a communist state with substantial limits to individual political freedom, in the economic sphere the country has moved sharply away from strict adherence to communist ideology. Other than China, communism hangs on only in a handful of small fringe states, such as North Korea and Cuba.



East and West Germans tear down the Berlin Wall on November 9, 1989. Berlin had been politically divided since the end of World War II, with the eastern portion of the city serving as the capital of the German Democratic Republic. The two parts of the city were physically divided in 1961 with the construction of the Berlin Wall.

Social democracy also seems to have passed a high-water mark, although the ideology may prove to be more enduring than communism. Social democracy has had perhaps its greatest influence in a number of democratic Western nations, including Australia, France, Germany, Great Britain, Norway, Spain, and Sweden, where Social Democratic parties have often held political power. Other countries where social democracy has had an important influence include India and Brazil. Consistent with their Marxists roots, many social democratic governments after World War II nationalized private companies in certain industries, transforming them into state-owned enterprises to be run for the "public good rather than private profit." In Great Britain by the end of the 1970s, for example, state-owned companies had a monopoly in the telecommunications, electricity, gas, coal, railway, and shipbuilding industries, as well as substantial interests in the oil, airline, auto, and steel industries.

However, experience demonstrated that state ownership of the means of production ran counter to the public interest. In many countries, state-owned companies performed poorly. Protected from competition by their monopoly position and guaranteed government financial support, many became increasingly inefficient. Individuals paid for the luxury of state ownership through higher prices and higher taxes. As a consequence, a number of Western democracies voted many Social Democratic parties out of office in the late 1970s and early 1980s. They were succeeded by political parties, such as Britain's Conservative Party and Germany's Christian Democratic Party, that were more committed to free market economics. These parties sold state-owned enterprises to private investors (a process referred to as **privatization**). Even where Social Democratic parties regained the levers of power, as in Great Britain in 1997 when the left-leaning Labor Party won control of the government, they too now seem committed to continued private ownership.

Individualism

The opposite of collectivism, **individualism** refers to a philosophy that an individual should have freedom in his or her economic and political pursuits. In contrast to collectivism, individualism stresses that the interests of the individual should take precedence over the interests of the state. Like collectivism, individualism can be traced to an ancient Greek philosopher, in this case Plato's disciple Aristotle (384–322 BC). In contrast to Plato, Aristotle argued that individual diversity and private ownership are desirable. In a passage that might have been taken from a speech by contemporary politicians who adhere to a free market ideology, he argued that private property is more highly productive than communal property and will thus stimulate progress. According to Aristotle, communal property receives little care, whereas property that is owned by an individual will receive the greatest care and therefore be most productive.

Individualism was reborn as an influential political philosophy in the Protestant trading nations of England and the Netherlands during the sixteenth century. The philosophy was refined in the work of a number of British philosophers, including David Hume (1711–76), Adam Smith (1723–90), and John Stuart Mill (1806–73). Individualism exercised a profound influence on those in the American colonies who sought independence from Great Britain. Indeed, the concept underlies the ideas expressed in the Declaration of Independence. In the twentieth century, several Nobel Prize–winning economists, including Milton Friedman, Friedrich von Hayek, and James Buchanan, have championed the philosophy.

Individualism is built on two central tenets. The first is an emphasis on the importance of guaranteeing individual freedom and self-expression. As John Stuart Mill put it,

> The sole end for which mankind are warranted, individually or collectively, in interfering with the liberty of action of any of their number is self-protection. . . . The only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others. His own good, either physical or moral, is not a sufficient warrant. . . . The only part of the conduct of any one, for which he is amenable to society, is that which concerns others. In the part which merely concerns himself, his independence is, of right, absolute. Over himself, over his own body and mind, the individual is sovereign.[5]

The second tenet of individualism is that the welfare of society is best served by letting people pursue their own economic self-interest, as opposed to some collective body (such as government) dictating what is in society's best interest. Or as Adam Smith put it in a famous passage from *The Wealth of Nations*, an individual who intends his own gain is

> led by an invisible hand to promote an end which was no part of his intention. Nor is it always worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who effect to trade for the public good.[6]

The central message of individualism, therefore, is that individual economic and political freedoms are the ground rules on which a society should be based. This puts individualism in conflict with collectivism. Collectivism asserts the primacy of the collective over the individual; individualism asserts the opposite. This underlying ideological conflict shaped much of the recent history of the world. The Cold War, for example, was in many respects a war between collectivism, championed by the former Soviet Union, and individualism, championed by the United States.

In practical terms, individualism translates into an advocacy for democratic political systems and market economics, which in general creates a more favorable environment for international businesses to operate in. From the late 1980s until about 2005, the waning of collectivism was matched by the ascendancy of individualism. Democratic ideals and market economics replaced socialism and communism in many states. The changes of this period went beyond the revolutions in Eastern Europe and the former Soviet Union to include a move toward greater individualism in Latin America and many of the social democratic states of the West (e.g., Great Britain and Sweden). Since 2005 there have been some signs of a swing back toward left-leaning socialist ideas in several countries, including several Latin America nations such as Venezuela, Bolivia, and Paraguay, along with Russia (see the accompanying Country Focus, which details what has been occurring in Venezuela). Also, the global financial crisis of 2008–2009 likely will cause some reevaluation of the trends of the past two decades, and the pendulum might tilt back the other way for a while.

DEMOCRACY AND TOTALITARIANISM

Democracy and totalitarianism are at different ends of a political dimension. **Democracy** refers to a political system in which government is by the people, exercised either directly or through elected representatives. **Totalitarianism** is a form of government in which one person or political party exercises absolute control over all spheres of human life and prohibits opposing political parties. The democratic–totalitarian dimension is not independent of the collectivism–individualism dimension. Democracy and individualism go hand in hand, as do the communist version of collectivism and totalitarianism. However, gray areas exist; it is possible to have a democratic state in which collective values predominate, and it is possible to have a totalitarian state that is hostile to collectivism and in which some degree of individualism—particularly in the economic sphere—is encouraged. For example, China has seen a move toward greater individual freedom in the economic sphere, but the country is still ruled by a totalitarian dictatorship that constrains political freedom.

Democracy

The pure form of democracy, as originally practiced by several city-states in ancient Greece, is based on a belief that citizens should be directly involved in decision making. In complex, advanced societies with populations in the tens or hundreds of millions this is impractical. Most modern democratic states practice **representative democracy**. In a representative democracy, citizens periodically elect individuals to represent them. These elected representatives then form a government, whose function is to make decisions on behalf of the electorate. In a representative democracy, elected representatives who fail to perform this job adequately will be voted out of office at the next election.

Chavez's Venezuela

Hugo Chavez, a former military officer who was once jailed for engineering a failed coup attempt, was elected president of Venezuela in 1998. Chavez, a self-styled democratic socialist, won the presidential election by campaigning against corruption, economic mismanagement, and the "harsh realities" of global capitalism. When he took office in February 1999, Chavez claimed he had inherited the worst economic situation in the country's recent history. He wasn't far off the mark. A collapse in the price of oil, which accounted for 70 percent of the country's exports, left Venezuela with a large budget deficit and forced the economy into a deep recession.

Soon after taking office, Chavez worked to consolidate his hold over the apparatus of government. A constituent assembly, dominated by Chavez followers, drafted a new constitution that strengthened the powers of the presidency and allowed Chavez (if reelected) to stay in office until 2012. Subsequently, the national congress, which was controlled by Chavez supporters, approved a measure allowing the government to remove and appoint Supreme Court justices, effectively increasing Chavez's hold over the judiciary. Chavez also extended government control over the media. By 2009, Freedom House, which annually assesses political and civil liberties worldwide, concluded Venezuela was only "partly free" and that freedoms were being progressively curtailed.

On the economic front, things remained rough. The economy shrank by 9 percent in 2002 and another 8 percent in 2003. Unemployment remained persistently high at 15 to 17 percent and the poverty rate rose to more than 50 percent of the population. A 2003 study by the World Bank concluded Venezuela was one of the most regulated economies in the world and that state controls over business activities gave public officials ample opportunities to enrich themselves by demanding bribes in return for permission to expand operations or enter new lines of business. Indeed, despite Chavez's anticorruption rhetoric, Transparency International, which ranks the world's nations according to the extent of public corruption, has noted that corruption has increased under Chavez. In 2011, Transparency International ranked Venezuela 164 out of 178 nations, down from 114 in 2004. Consistent with his socialist rhetoric, Chavez has progressively taken various enterprises into state ownership and has required that other enterprises be restructured as "workers' cooperatives" in return for government loans. In addition, the government has begun to seize large rural farms and ranches that Chavez claims are not sufficiently productive, turning them into state-owned cooperatives.

In 2004, the world oil market bailed Chavez out of mounting economic difficulties. Oil prices started to surge from the low $20s, reaching $150 a barrel by mid-2008, and Venezuela, the world's fifth-largest producer, started to reap a bonanza. On the back of surging oil exports, the economy grew at a robust rate. Chavez used the oil revenues to boost government spending on social programs, many of them modeled after programs in Cuba. As a result, the government's share of GDP increased from 20 percent at the end of the 1990s to almost 40 percent in 2008. Chavez also extended government control over foreign oil producers doing business in Venezuela, which he accused of making outsize profits at the expense of a poor nation. In 2005, he announced an increase in the royalties the government would collect from oil sales from 1 percent to 30 percent, and he increased the tax rate on sales from 34 to 50 percent. In 2006, he announced plans to reduce the stakes held by foreign companies in oil projects in the Orinoco regions and to give the state-run oil company, Petroleos de Venezuela SA, a majority position. However, despite strong global demand, oil production in Venezuela appears to be slipping, having fallen every year since 2006. Moreover, when oil prices fell in 2008–2009, the Venezuelan economy went into reverse, shrinking by 3.3 percent in 2009 and 2.8 percent in 2010.

Riding a wave of popularity at home, in December 2006 Chavez won reelection as president. He celebrated his victory by stepping on the revolutionary accelerator. Parliament gave him the power to legislate by decree for 18 months, and a committee of his supporters started to draft a constitutional reform to turn Venezuela into an avowedly socialist country and to allow the president to stand for reelection indefinitely. However, in a sign that Chavez's popularity has limits, in a December 2, 2007, nationwide referendum, Venezuelan voters narrowly rejected a revised constitution that would have placed more power in Chavez's hands. Despite this, in late 2010 Chavez yet again persuaded the National Assembly, where his supporters dominated, to once more grant him the power to rule by decree for another 18 months.[7]

To guarantee that elected representatives can be held accountable for their actions by the electorate, an ideal representative democracy has a number of safeguards that are typically enshrined in constitutional law. These include (1) an individual's right to freedom of expression, opinion, and organization; (2) a free media; (3) regular elections in which all eligible citizens are allowed to vote; (4) universal adult suffrage; (5) limited terms for elected representatives; (6) a fair court system that is independent from the political system; (7) a nonpolitical state bureaucracy; (8) a nonpolitical police force and armed service; and (9) relatively free access to state information.[8]

Totalitarianism

In a totalitarian country, all the constitutional guarantees on which representative democracies are built—an individual's right to freedom of expression and organization, a free media, and regular elections—are denied to the citizens. In most totalitarian states, political repression is widespread, free and fair elections are lacking, media are heavily censored, basic civil liberties are denied, and those who question the right of the rulers to rule find themselves imprisoned, or worse.

Four major forms of totalitarianism exist in the world today. Until recently, the most widespread was **communist totalitarianism**. Communism, however, is in decline worldwide, and most of the Communist Party dictatorships have collapsed since 1989. Exceptions to this trend (so far) are China, Vietnam, Laos, North Korea, and Cuba, although most of these states exhibit clear signs that the Communist Party's monopoly on political power is retreating. In many respects, the governments of China, Vietnam, and Laos are communist in name only since those nations now adhere to market-based economic reforms. They remain, however, totalitarian states that deny many basic civil liberties to their populations. On the other hand, there are signs of a swing back toward communist totalitarian ideas in some states, such as Venezuela, where the government of Hugo Chavez is starting to display totalitarian tendencies (see the Country Focus).

A second form of totalitarianism might be labeled **theocratic totalitarianism**. Theocratic totalitarianism is found in states where political power is monopolized by a party, group, or individual that governs according to religious principles. The most common form of theocratic totalitarianism is based on Islam and is exemplified by states such as Iran and Saudi Arabia. These states limit freedom of political and religious expression with laws based on Islamic principles.

A third form of totalitarianism might be referred to as **tribal totalitarianism**. Tribal totalitarianism has arisen from time to time in African countries such as Zimbabwe, Tanzania, Uganda, and Kenya. The borders of most African states reflect the administrative boundaries drawn by the old European colonial powers rather than tribal realities. Consequently, the typical African country contains a number of tribes (for example, in Kenya there are more than 40 tribes). Tribal totalitarianism occurs when a political party that represents the interests of a particular tribe (and not always the majority tribe) monopolizes power. Such one-party states still exist in Africa.

A fourth major form of totalitarianism might be described as **right-wing totalitarianism**. Right-wing totalitarianism generally permits some individual economic freedom but restricts individual political freedom, frequently on the grounds that it would lead to the rise of communism. A common feature of many right-wing dictatorships is an overt hostility to socialist or communist ideas. Many right-wing totalitarian governments are backed by the military, and in some cases the government may be made up of military officers. The fascist regimes that ruled Germany and Italy in the 1930s and 1940s were right-wing totalitarian states. Until the early 1980s, right-wing dictatorships, many of which were military dictatorships, were common throughout Latin America. They were also found in several Asian countries, particularly South Korea, Taiwan, Singapore, Indonesia, and the Philippines. Since the early 1980s, however, this form of government has been in retreat. Most Latin American countries are now genuine multiparty democracies. Similarly, South Korea, Taiwan, and the Philippines have all become functioning democracies, as has Indonesia.

LO2

Economic Systems

It should be clear from the previous section that political ideology and economic systems are connected. In countries where individual goals are given primacy over collective goals, we are more likely to find market-based economic systems. In contrast, in countries where collective goals are given preeminence, the state may have taken control over many enterprises; markets in such countries are likely to be restricted rather than free. We can identify three broad types of economic systems—a market economy, a command economy, and a mixed economy.

MARKET ECONOMY

In the archetypal *pure* **market economy**, all productive activities are privately owned, as opposed to being owned by the state. The goods and services that a country produces are not planned by anyone. Production is determined by the interaction of supply and demand and signaled to producers through the price system. If demand for a product exceeds supply, prices will rise, signaling producers to produce more. If supply exceeds demand, prices will fall, signaling producers to produce less. In this system consumers are sovereign. The purchasing patterns of consumers, as signaled to producers through the mechanism of the price system, determine what is produced and in what quantity.

For a market to work in this manner, supply must not be restricted. A supply restriction occurs when a single firm monopolizes a market. In such circumstances, rather than increase output in response to increased demand, a monopolist might restrict output and let prices rise. This allows the monopolist to take a greater profit margin on each unit it sells. Although this is good for the monopolist, it is bad for the consumer, who has to pay higher prices. It also is probably bad for the welfare of society. Since a monopolist has no competitors, it has no incentive to search for ways to lower production costs. Rather, it can simply pass on cost increases to consumers in the form of higher prices. The net result is that the monopolist is likely to become increasingly inefficient, producing high-priced, low-quality goods, and society suffers as a consequence.

Given the dangers inherent in monopoly, the role of government in a market economy is to encourage vigorous free and fair competition between private producers. Governments do this by outlawing restrictive business practices designed to monopolize a market (antitrust laws serve this function in the United States). Private ownership also encourages vigorous competition and economic efficiency. Private ownership ensures that entrepreneurs have a right to the profits generated by their own efforts. This gives entrepreneurs an incentive to search for better ways of serving consumer needs. That may be through introducing new products, by developing more efficient production processes, by pursuing better marketing and after-sale service, or simply through managing their businesses more efficiently than their competitors. In turn, the constant improvement in product and process that results from such an incentive has been argued to have a major positive impact on economic growth and development.[9]

COMMAND ECONOMY

In a *pure* **command economy**, the government plans the goods and services that a country produces, the quantity in which they are produced, and the prices at which they are sold. Consistent with the collectivist ideology, the objective of a command economy is for government to allocate resources for "the good of society." In addition, in a pure command economy, all businesses are state owned, the rationale being that the government can then direct them to make investments that are in the best interests of the nation as a whole rather than in the interests of private individuals. Historically, command economies were found in communist countries where collectivist goals were given priority over individual goals. Since the demise of communism in the late 1980s, the number of command economies has fallen dramatically. Some elements of a command economy were

also evident in a number of democratic nations led by socialist-inclined governments. France and India both experimented with extensive government planning and state ownership, although government planning has fallen into disfavor in both countries.

While the objective of a command economy is to mobilize economic resources for the public good, the opposite seems to have occurred. In a command economy, state-owned enterprises have little incentive to control costs and be efficient, because they cannot go out of business. Also, the abolition of private ownership means there is no incentive for individuals to look for better ways to serve consumer needs; hence, dynamism and innovation are absent from command economies. Instead of growing and becoming more prosperous, such economies tend to stagnate.

MIXED ECONOMY

Between market economies and command economies can be found mixed economies. In a mixed economy, certain sectors of the economy are left to private ownership and free market mechanisms while other sectors have significant state ownership and government planning. Mixed economies were once common throughout much of the world, although they are becoming much less so. Until the 1980s, Great Britain, France, and Sweden were mixed economies, but extensive privatization has reduced state ownership of businesses in all three nations. A similar trend occurred in many other countries where there was once a large state-owned sector, such as Brazil, Italy, and India (there are still state-owned enterprises in all of these nations).

In mixed economies, governments also tend to take into state ownership troubled firms whose continued operation is thought to be vital to national interests. Consider, for example, the French automobile company Renault. The government took over the company when it ran into serious financial problems. The French government reasoned that the social costs of the unemployment that might result if Renault collapsed were unacceptable, so it nationalized the company to save it from bankruptcy. Renault's competitors weren't thrilled by this move because they had to compete with a company whose costs were subsidized by the state. Similarly, in 2008 and early 2009 the U.S. government took an 80 percent stake in AIG to stop that financial institution from collapsing, the theory being that if AIG did collapse, it would have very serious consequences for the entire financial system. The U.S. government usually prefers market-oriented solutions to economic problems, and in the AIG case the intention was to sell the institution back to private investors as soon as possible. The United States also took similar action with respect to a number of other troubled private enterprises, including Citigroup and General Motors. In all of these cases, the government stake was seen as nothing more than a short-term action designed to stave off economic collapse by injecting capital into troubled enterprises. As soon as it was able to, the government sold these stakes (in early 2010, for example, it sold its stake in Citigroup, for a profit, and in late 2010 it sold much of its stake in GM to public investors).

Legal Systems

LO3

The **legal system** of a country refers to the rules, or laws, that regulate behavior along with the processes by which the laws are enforced and through which redress for grievances is obtained. The legal system of a country is of immense importance to international business. A country's laws regulate business practice, define the manner in which business transactions are to be executed, and set down the rights and obligations of those involved in business transactions. The legal environments of countries differ in significant ways. As we shall see, differences in legal systems can affect the attractiveness of a country as an investment site or market.

Like the economic system of a country, the legal system is influenced by the prevailing political system (although it is also strongly influenced by historical tradition). The government of a country defines the legal framework within which firms do

business, and often the laws that regulate business reflect the rulers' dominant political ideology. For example, collectivist-inclined totalitarian states tend to enact laws that severely restrict private enterprise, whereas the laws enacted by governments in democratic states where individualism is the dominant political philosophy tend to be pro-private enterprise and pro-consumer.

Here we focus on several issues that illustrate how legal systems can vary—and how such variations can affect international business. First, we look at some basic differences in legal systems. Next we look at contract law. Third, we look at the laws governing property rights with particular reference to patents, copyrights, and trademarks. Then we discuss protection of intellectual property. Finally, we look at laws covering product safety and product liability.

DIFFERENT LEGAL SYSTEMS

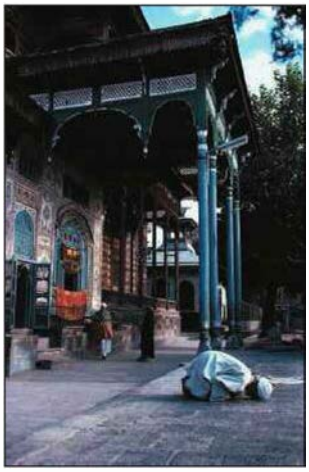
There are three main types of legal systems—or legal tradition—in use around the world: common law, civil law, and theocratic law.

Common Law

The common law system evolved in England over hundreds of years. It is now found in most of Great Britain's former colonies, including the United States. **Common law** is based on tradition, precedent, and custom. *Tradition* refers to a country's legal history, *precedent* to cases that have come before the courts in the past, and *custom* to the ways in which laws are applied in specific situations. When law courts interpret common law, they do so with regard to these characteristics. This gives a common law system a degree of flexibility that other systems lack. Judges in a common law system have the power to interpret the law so that it applies to the unique circumstances of an individual case. In turn, each new interpretation sets a precedent that may be followed in future cases. As new precedents arise, laws may be altered, clarified, or amended to deal with new situations.

Civil Law

A **civil law system** is based on a detailed set of laws organized into codes. When law courts interpret civil law, they do so with regard to these codes. More than 80 countries, including Germany, France, Japan, and Russia, operate with a civil law system. A civil law system tends to be less adversarial than a common law system, since the judges rely upon detailed legal codes rather than interpreting tradition, precedent, and custom. Judges under a civil law system have less flexibility than those under a common law system. Judges in a common law system have the power to interpret the law, whereas judges in a civil law system have the power only to apply the law.



Islamic law governs all aspects of the Muslims' lives, even commercial activities.

Theocratic Law

A **theocratic law system** is one in which the law is based on religious teachings. Islamic law is the most widely practiced theocratic legal system in the modern world, although usage of both Hindu and Jewish law persisted into the twentieth century. Islamic law is primarily a moral rather than a commercial law and is intended to govern all aspects of life.[10] The foundation for Islamic law is the holy book of Islam, the Koran, along with the Sunnah, or decisions and sayings of the Prophet Muhammad, and the writings of Islamic scholars who have derived rules by analogy from the principles established in the Koran and the Sunnah. Because the Koran and Sunnah are holy documents, the basic foundations of Islamic law cannot be changed. However, in practice Islamic jurists and scholars are constantly debating the application of Islamic law to the modern world. In reality, many Muslim countries have legal systems that are a blend of Islamic law and a common or civil law system.

Although Islamic law is primarily concerned with moral behavior, it has been extended to cover certain commercial activities. An example is the payment or receipt

of interest, which is considered usury and outlawed by the Koran. To the devout Muslim, acceptance of interest payments is seen as a grave sin; the giver and the taker are equally damned. This is not just a matter of theology; in several Islamic states it has also become a matter of law. In the 1990s, for example, Pakistan's Federal Shariat Court, the highest Islamic lawmaking body in the country, pronounced interest to be un-Islamic and therefore illegal and demanded that the government amend all financial laws accordingly. In 1999, Pakistan's Supreme Court ruled that Islamic banking methods should be used in the country after July 1, 2001.[11] By 2008, some 500 Islamic financial institutions in the world collectively managed more than $500 billion in assets. In addition to Pakistan, Islamic financial institutions are found in many of the Gulf states, Egypt, and Malaysia.[12]

DIFFERENCES IN CONTRACT LAW

The difference between common law and civil law systems can be illustrated by the approach of each to contract law (remember, most theocratic legal systems also have elements of common or civil law). A **contract** is a document that specifies the conditions under which an exchange is to occur and details the rights and obligations of the parties involved. Some form of contract regulates many business transactions. **Contract law** is the body of law that governs contract enforcement. The parties to an agreement normally resort to contract law when one party feels the other has violated either the letter or the spirit of an agreement.

Because common law tends to be relatively ill specified, contracts drafted under a common law framework tend to be very detailed with all contingencies spelled out. In civil law systems, however, contracts tend to be much shorter and less specific because many of the issues are already covered in a civil code. Thus, it is more expensive to draw up contracts in a common law jurisdiction, and resolving contract disputes can be very adversarial in common law systems. But common law systems have the advantage of greater flexibility and allow for judges to interpret a contract dispute in light of the prevailing situation. International businesses need to be sensitive to these differences; approaching a contract dispute in a state with a civil law system as if it had a common law system may backfire, and vice versa.

When contract disputes arise in international trade, there is always the question of which country's laws to apply. To resolve this issue, a number of countries, including the United States, have ratified the **United Nations Convention on Contracts for the International Sale of Goods (CIGS)**. The CIGS establishes a uniform set of rules governing certain aspects of the making and performance of everyday commercial contracts between sellers and buyers who have their places of business in different nations. By adopting the CIGS, a nation signals to other adopters that it will treat the convention's rules as part of its law. The CIGS applies automatically to all contracts for the sale of goods between different firms based in countries that have ratified the convention, unless the parties to the contract explicitly opt out. One problem with the CIGS, however, is that fewer than 70 nations have ratified the convention (the CIGS went into effect in 1988).[13] Many of the world's larger trading nations, including Japan and the United Kingdom, have not ratified the CIGS.

When firms do not wish to accept the CIGS, they often opt for arbitration by a recognized arbitration court to settle contract disputes. The most well known of these courts is the International Court of Arbitration of the International Chamber of Commerce in Paris, which handles more than 500 requests per year from over 100 countries.[14]

PROPERTY RIGHTS AND CORRUPTION

In a legal sense, the term *property* refers to a resource over which an individual or business holds a legal title, that is, a resource that it owns. Resources include land,

buildings, equipment, capital, mineral rights, businesses, and intellectual property (ideas, which are protected by patents, copyrights, and trademarks). **Property rights** refer to the legal rights over the use to which a resource is put and over the use made of any income that may be derived from that resource.[15] Countries differ in the extent to which their legal systems define and protect property rights. Almost all countries now have laws on their books that protect property rights. Even China, still nominally a communist state despite its booming market economy, finally enacted a law to protect the rights of private property holders in 2007 (the law gives individuals the same legal protection for their property as the state has).[16] However, in many countries, these laws are not enforced by the authorities and property rights are violated. Property rights can be violated in two ways—through private action and through public action.

Private Action

In this context, **private action** refers to theft, piracy, blackmail, and the like by private individuals or groups. Although theft occurs in all countries, a weak legal system allows for a much higher level of criminal action in some than in others. For example, in Russia in the chaotic period following the collapse of communism, an outdated legal system, coupled with a weak police force and judicial system, offered both domestic and foreign businesses scant protection from blackmail by the "Russian Mafia." Successful business owners in Russia often had to pay "protection money" to the Mafia or face violent retribution, including bombings and assassinations (about 500 contract killings of businessmen occurred in 1995 and again in 1996).[17]

Russia is not alone in having Mafia problems (and the situation in Russia has improved significantly since the mid-1990s). The Mafia has a long history in the United States (Chicago in the 1930s was similar to Moscow in the 1990s). In Japan, the local version of the Mafia, known as the *yakuza*, runs protection rackets, particularly in the food and entertainment industries.[18] However, there was a big difference between the magnitude of such activity in Russia in the 1990s and its limited impact in Japan and the United States. This difference arose because the legal enforcement apparatus, such as the police and court system, was weak in Russia following the collapse of communism. Many other countries from time to time have had problems similar to or even greater than those experienced by Russia.

Public Action and Corruption

Public action to violate property rights occurs when public officials, such as politicians and government bureaucrats, extort income, resources, or the property itself from property holders. This can be done through legal mechanisms such as levying excessive taxation, requiring expensive licenses or permits from property holders, taking assets into state ownership without compensating the owners, or redistributing assets without compensating the prior owners. It can also be done through illegal means, or corruption, by demanding bribes from businesses in return for the rights to operate in a country, industry, or location.[19]

Corruption has been well documented in every society, from the banks of the Congo River to the palace of the Dutch royal family, from Japanese politicians to Brazilian bankers, and from Indonesian government officials to the New York City Police Department. The government of the late Ferdinand Marcos in the Philippines was famous for demanding bribes from foreign businesses wishing to set up operations in that country.[20] The same was true of government officials in Indonesia under the rule of former president Suharto. No society is immune to corruption. However, there are systematic differences in the extent of corruption. In some countries, the rule of law minimizes corruption. Corruption is seen and treated as illegal, and when discovered, violators are punished by the full force of the law. In other countries, the rule of law is weak and corruption by bureaucrats and politicians is rife. Corruption is so endemic in some

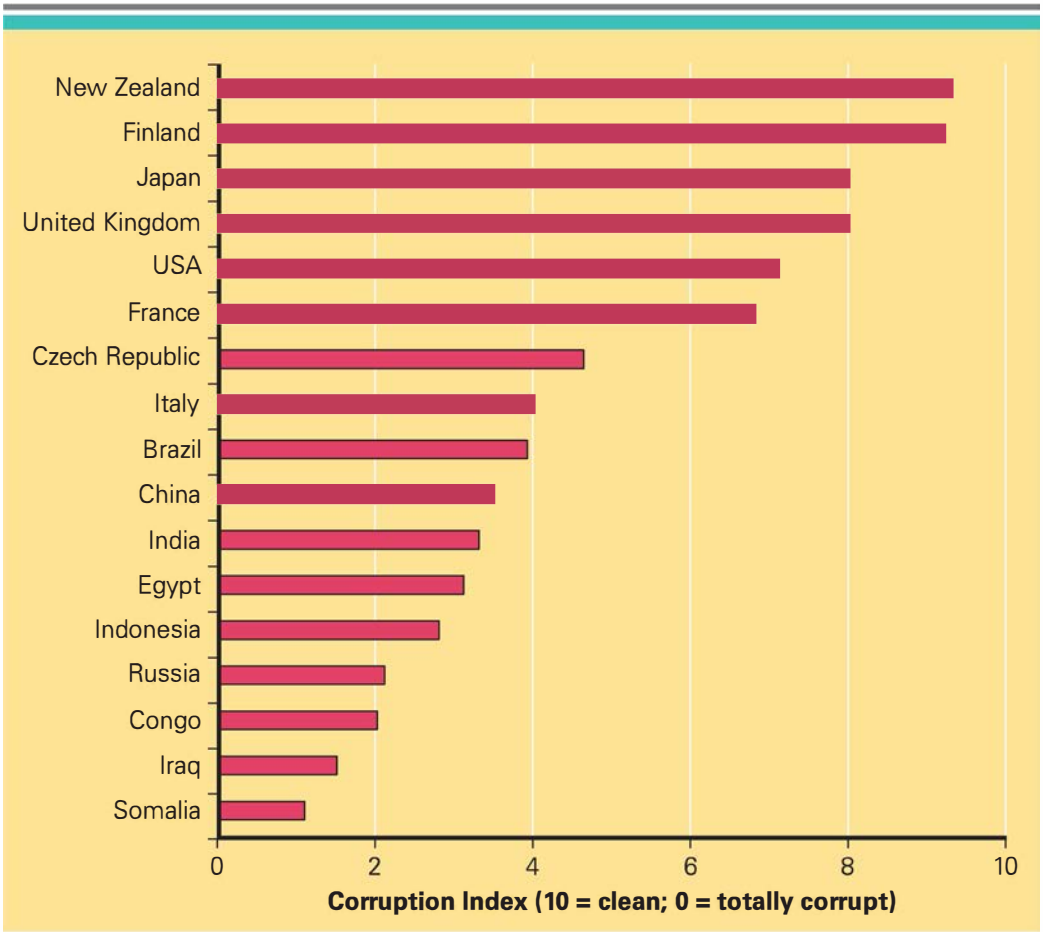


FIGURE 2.1

Rankings of Corruption by Country 2010

Source: Constructed by the author from raw data in Transparency International, *Global Corruption Report*, 2011.

countries that politicians and bureaucrats regard it as a perk of office and openly flout laws against corruption.

According to Transparency International, an independent nonprofit organization dedicated to exposing and fighting corruption, businesses and individuals spend some $400 billion a year worldwide on bribes related to government procurement contracts alone.[21] Transparency International has also measured the level of corruption among public officials in different countries.[22] As can be seen in Figure 2.1, the organization rated countries such as Finland and New Zealand as clean; it rated others, such as Russia, India, and Indonesia, as corrupt. Somalia ranked last out of all 178 countries in the survey (the country is often described as a "failed state").

Economic evidence suggests that high levels of corruption significantly reduce the foreign direct investment, level of international trade, and economic growth rate in a country.[23] By siphoning off profits, corrupt politicians and bureaucrats reduce the returns to business investment and, hence, reduce the incentive of both domestic and foreign businesses to invest in that country. The lower level of investment that results hurts economic growth. Thus, we would expect countries such as Indonesia, Nigeria, and Russia to have a much lower rate of economic growth than might otherwise have been the case. A detailed example of the negative effect that corruption can have on economic progress is given in the accompanying Country Focus, which looks at the impact of corruption on economic growth in Nigeria.

Foreign Corrupt Practices Act

In the 1970s, the United States passed the **Foreign Corrupt Practices Act** following revelations that U.S. companies had bribed government officials in foreign countries

Corruption in Nigeria

When Nigeria gained independence from Great Britain in 1960, there were hopes that the country might emerge as an economic heavyweight in Africa. Not only was Nigeria Africa's most populous country, but it also was blessed with abundant natural resources, particularly oil, from which the country earned over $550 billion between 1970 and 2009. Despite this, Nigeria remains one of the poorest countries in the world. According to the 2008 Human Development Index compiled by the United Nations, Nigeria had "low human development." The country ranked 154 out of 177 covered. Gross domestic product per capita was just $1,852, 29 percent of the adult population was illiterate, and life expectancy at birth was only 46.6 years.

What went wrong? Although there is no simple answer, a number of factors seem to have conspired to damage economic activity in Nigeria. The country is composed of several competing ethnic, tribal, and religious groups, and the conflict among them has limited political stability and led to political strife, including a brutal civil war in the 1970s. With the legitimacy of the government always in question, political leaders often purchased support by legitimizing bribes and by raiding the national treasury to reward allies. Civilian rule after independence was followed by a series of military dictatorships, each of which seemed more corrupt and inept than the last (the country returned to civilian rule in 1999).

During the 1990s, the military dictator Sani Abacha openly and systematically plundered the state treasury for his own personal gain. His most blatant scam was the Petroleum Trust Fund, which he set up in the mid-1990s ostensibly to channel extra revenue from an increase in fuel prices into much-needed infrastructure projects and other investments. The fund was not independently audited, and almost none of the money that passed through it was properly accounted for. It was, in fact, a vehicle for Abacha and his supporters to spend at will a sum that in 1996 was equivalent to some 25 percent of the total federal budget. Abacha, aware of his position as an unpopular and unelected leader, lavished money on personal security and handed out bribes to those whose support he coveted. With examples like this at the very top of the government, it is not surprising that corruption could be found throughout the political and bureaucratic apparatus.

Some of the excesses were simply astounding. In the 1980s an aluminum smelter was built on the orders of the government, which wanted to industrialize Nigeria. The cost of the smelter was $2.4 billion, some 60 to 100 percent higher than the cost of comparable plants elsewhere in the developed world. This high cost was widely interpreted to reflect the bribes that had to be paid to local politicians by the international contractors that built the plant. The smelter has never operated at more than a fraction of its intended capacity.

Has the situation in Nigeria improved since the country returned to civilian rule in 1999? In 2003, Olusegun Obasanjo was elected president on a platform that included a promise to fight corruption. By some accounts, progress has been seen. His anticorruption chief, Nuhu Ribadu, claimed that whereas 70 percent of the country's oil revenues were being stolen or wasted in 2002, by 2004 the figure was "only" 40 percent. But in its most recent survey, Transparency International still ranked Nigeria among the most corrupt countries in the world in 2009, suggesting that the country still has long way to go. In an effort to move things along, in 2007 the country's top anticorruption body, the Economic and Financial Crimes Commission, sent letters to political parties listing 130 candidates for upcoming elections who it stated would soon be charged with corruption. Several parties responded by removing candidates identified as corrupt from their lists. Others argued that the list was itself influenced by political motives and in particular a desire to strengthen the position of then-President Obasanjo and his hand-picked successor, President Umaru Yar'Adua, by blacklisting opponents.[24]

in an attempt to win lucrative contracts. This law makes it illegal to bribe a foreign government official to obtain or maintain business over which that foreign official has authority, and it requires all publicly traded companies (whether or not they are involved in international trade) to keep detailed records that would reveal whether a violation of the act has occurred. Along the same lines, in 1997 trade and finance ministers from the member states of the Organization for Economic Cooperation and Development (OECD), an association of the world's 30 most powerful economies, adopted the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.[25] The convention obliges member states to make the bribery of foreign public officials a criminal offense.

However, both the U.S. law and OECD convention include language that allows for exceptions known as facilitating or expediting payments (also called *grease payments* or *speed money*), the purpose of which is to expedite or to secure the performance of a routine governmental action.[26] For example, they allow for small payments made to speed up the issuance of permits or licenses, process paperwork, or just get vegetables off the dock and on their way to market. The explanation for this exception to general antibribery provisions is that while grease payments are, technically, bribes, they are distinguishable from (and, apparently, less offensive than) bribes used to obtain or maintain business because they merely facilitate performance of duties that the recipients are already obligated to perform.

THE PROTECTION OF INTELLECTUAL PROPERTY

Intellectual property refers to property that is the product of intellectual activity, such as computer software, a screenplay, a music score, or the chemical formula for a new drug. Patents, copyrights, and trademarks establish ownership rights over intellectual property. A **patent** grants the inventor of a new product or process exclusive rights for a defined period to the manufacture, use, or sale of that invention. **Copyrights** are the exclusive legal rights of authors, composers, playwrights, artists, and publishers to publish and disperse their work as they see fit. **Trademarks** are designs and names, often officially registered, by which merchants or manufacturers designate and differentiate their products (e.g., Christian Dior clothes). In the high-technology "knowledge" economy of the twenty-first century, intellectual property has become an increasingly important source of economic value for businesses. Protecting intellectual property has also become increasingly problematic, particularly if it can be rendered in a digital form and then copied and distributed at very low cost via pirated CDs or over the Internet (e.g., computer software, music and video recordings).[27]

The philosophy behind intellectual property laws is to reward the originator of a new invention, book, musical record, clothes design, restaurant chain, and the like, for his or her idea and effort. Such laws stimulate innovation and creative work. They provide an incentive for people to search for novel ways of doing things, and they reward creativity. For example, consider innovation in the pharmaceutical industry. A patent will grant the inventor of a new drug a 20-year monopoly in production of that drug. This gives pharmaceutical firms an incentive to undertake the expensive, difficult, and time-consuming basic research required to generate new drugs (it can cost $800 million in R&D and take 12 years to get a new drug on the market). Without the guarantees provided by patents, companies would be unlikely to commit themselves to extensive basic research.[28]



A security guard stands near a pile of pirated CDs and DVDs before they were destroyed at a ceremony in Beijing on Saturday, Feb. 26, 2005. Thousands of pirated items were destroyed in the event, one of a number of activities, including an antipiracy pop concert later Saturday, which were staged by China's government to publicize its antipiracy efforts.

The protection of intellectual property rights differs greatly from country to country. Although many countries have stringent intellectual property regulations on their books, the enforcement of these regulations has often been lax. This has been the case even among many of the 183 countries that are now members of the **World Intellectual Property Organization**, all of which have signed international treaties designed to protect intellectual property, including the oldest such treaty, the **Paris Convention for the Protection of Industrial Property**, which dates to 1883 and has been signed by some 170 nations. Weak enforcement encourages the piracy (theft) of intellectual property. China and Thailand have recently been among the worst offenders in Asia. Pirated computer software is widely available in China. Similarly, the streets of Bangkok, Thailand's capital, are lined with stands selling pirated copies of Rolex watches, Levi Strauss jeans, videotapes, and computer software.

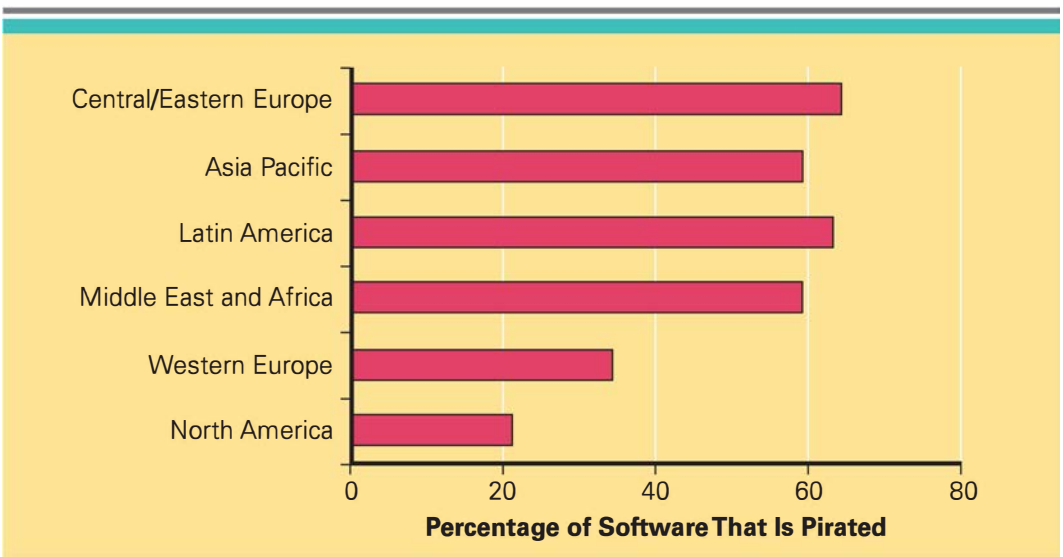
Piracy in music recordings is rampant. The International Federation of the Phonographic Industry claims that about one-third of all recorded music products sold worldwide are pirated (illegal) copies, suggesting that piracy costs the industry more than $4.5 billion annually.[29] The computer software industry also suffers from lax enforcement of intellectual property rights. Estimates suggest that violations of intellectual property rights cost personal computer software firms revenues equal to $51.4 billion in 2009.[30] According to the Business Software Alliance, a software industry association, in 2009 some 43 percent of all software applications used in the world were pirated. The worst region was Central and Eastern Europe where the piracy rate was 64 percent (see Figure 2.2). One of the worst countries was China, where the piracy rate in 2009 ran at 79 percent and cost the industry more than $7.6 billion in lost sales, up from $444 million in 1995. The piracy rate in the United States was much lower at 20 percent; however, the value of sales lost was more significant because of the size of the U.S. market, reaching an estimated $8.4 billion in 2009.[31]

International businesses have a number of possible responses to violations of their intellectual property. They can lobby their respective governments to push for international agreements to ensure that intellectual property rights are protected and that the law is enforced. Partly as a result of such actions, international laws are being strengthened. As we shall see in Chapter 6, the most recent world trade agreement, signed in 1994, for the first time extends the scope of the General Agreement on Tariffs and Trade to cover intellectual property. Under the new agreement, known as the Trade Related Aspects of Intellectual Property Rights (or TRIPS), as of 1995 a council of the World Trade Organization is overseeing enforcement of much stricter intellectual property

FIGURE 2.2

Regional Piracy Rates for Software, 2009

Source: From Business Software Alliance, "Seventh Annual BSA and IDC Global Software Piracy Study," May 2010, www.bsa.org, accessed April 7, 2011. Reprinted with permission.



MANAGEMENT FOCUS

Starbucks Wins Key Trademark Case in China

Starbucks has big plans for China. It believes the fast-growing nation will become the company's second-largest market after the United States. Starbucks entered the country in 1999, and by the end of 2007 it had more than 300. But in China, copycats of well-established Western brands are common. Starbucks too faced competition from a look-alike, Shanghai Xing Ba Ke Coffee Shop, whose stores closely matched the Starbucks format, right down to a green-and-white Xing Ba Ke circular logo that mimics Starbucks' ubiquitous logo. The name also mimics the standard Chinese translation for Starbucks. *Xing* means "star" and *Ba Ke* sounds like "bucks."

In 2003, Starbucks decided to sue Xing Ba Ke in Chinese court for trademark violations. Xing Ba Ke's general manager responded by claiming it was just an accident that the logo and name were so similar to that of Starbucks. He claimed the right to use the logo and name because Xing Ba Ke had registered as a company in Shanghai in 1999, before Starbucks entered the city. "I hadn't heard of Starbucks at the time," claimed the manager, "so how could I imitate its brand and logo?"

However, in January 2006 a Shanghai court ruled that Starbucks had precedence, in part because it had registered its Chinese name in 1998. The court stated that Xing Ba Ke's use of the name and similar logo was "clearly malicious" and constituted improper competition. The court ordered Xing Ba Ke to stop using the name and to pay Starbucks $62,000 in compensation. While the money involved here may be small, the precedent is not. In a country where violation of trademarks has been common, the courts seem to be signaling a shift toward greater protection of intellectual property rights. This is perhaps not surprising, since foreign governments and the World Trade Organization have been pushing China hard recently to start respecting intellectual property rights.[33]

regulations. These regulations oblige WTO members to grant and enforce patents lasting at least 20 years and copyrights lasting 50 years. Rich countries had to comply with the rules within a year. Poor countries, in which such protection generally was much weaker, had five years of grace, and the very poorest have 10 years.[32] (For further details of the TRIPS agreement, see Chapter 7.)

In addition to lobbying governments, firms can file lawsuits on their own behalf. For example, Starbucks won a landmark trademark copyright case in China against a copycat (see the accompanying Management Focus for details). Firms may also choose to stay out of countries where intellectual property laws are lax, rather than risk having their ideas stolen by local entrepreneurs. Firms also need to be on the alert to ensure that pirated copies of their products produced in countries with weak intellectual property laws don't turn up in their home market or in third countries. U.S. computer software giant Microsoft, for example, discovered that pirated Microsoft software, produced illegally in Thailand, was being sold worldwide as the real thing.

PRODUCT SAFETY AND PRODUCT LIABILITY

Product safety laws set certain safety standards to which a product must adhere. **Product liability** involves holding a firm and its officers responsible when a product causes injury, death, or damage. Product liability can be much greater if a product does not conform to required safety standards. Both civil and criminal product liability laws exist. Civil laws call for payment and monetary damages. Criminal liability laws result in fines or imprisonment. Both civil and criminal liability laws are probably more

extensive in the United States than in any other country, although many other Western nations also have comprehensive liability laws. Liability laws are typically least extensive in less developed nations. A boom in product liability suits and awards in the United States resulted in a dramatic increase in the cost of liability insurance. Many business executives argue that the high costs of liability insurance make American businesses less competitive in the global marketplace.

In addition to the competitiveness issue, country differences in product safety and liability laws raise an important ethical issue for firms doing business abroad. When product safety laws are tougher in a firm's home country than in a foreign country or when liability laws are more lax, should a firm doing business in that foreign country follow the more relaxed local standards or should it adhere to the standards of its home country? While the ethical thing to do is undoubtedly to adhere to home-country standards, firms have been known to take advantage of lax safety and liability laws to do business in a manner that would not be allowed at home.

IMPLICATIONS FOR MANAGERS

LO4



The material discussed in this chapter has two broad implications for international business. First, the political, economic, and legal systems of a country raise important ethical issues that have implications for the practice of international business. For example, what ethical implications are associated with doing business in totalitarian countries where citizens are denied basic human rights, corruption is rampant, and bribes are necessary to gain permission to do business? Is it right to operate in such a setting? A full discussion of the ethical implications of country differences in political economy is reserved for Chapter 5, where we explore ethics in international business in much greater depth.

Second, the political, economic, and legal environments of a country clearly influence the attractiveness of that country as a market or investment site. The benefits, costs, and risks associated with doing business in a country are a function of that country's political, economic, and legal systems. The overall attractiveness of a country as a market or investment site depends on balancing the likely long-term benefits of doing business in that country against the likely costs and risks. Since this chapter is the first of two dealing with issues of political economy, we will delay a detailed discussion of how political economy impacts the benefits, costs, and risks of doing business in different nation-states until the end of the next chapter, when we have a full grasp of all the relevant variables that are important for assessing benefits, costs, and risks.

For now, other things being equal, a nation with democratic political institutions, a market-based economic system, and strong legal system that protects property rights and limits corruption is clearly more attractive as a place in which to do business than a nation that lack democratic institutions, where economic activity is heavily regulated by the state, and where corruption is rampant and the rule of law is not respected. On this basis, for example, Poland is a better place in which to do business than the Venezuela of Hugo Chavez (see the opening case and the Country Focus on Venezuela). That being said, the reality is often more nuanced and complex. For example, China lacks democratic institutions, corruption is widespread, property rights are not always respected, and even though the country has embraced many market-based economic reforms, there are still large numbers of state-owned enterprises, yet many Western businesses feel that they must invest in China. They do so despite the risks because the market is

large, the nation is moving toward a market-based system, economic growth is strong, legal protection of property rights has been improving, and in the not too distant future China may become the largest economy in the world. Thus, China is becoming increasingly attractive as a place in which to do business, and given the future growth trajectory, significant opportunities may be lost by not investing in the country. We will explore how changes in political economy impact the attractiveness of a nation as a place in which to do business in the next chapter.

CHAPTER SUMMARY

This chapter has reviewed how the political, economic, and legal systems of countries vary. The potential benefits, costs, and risks of doing business in a country are a function of its political, economic, and legal systems. The chapter made the following points:

1. Political systems can be assessed according to two dimensions: the degree to which they emphasize collectivism as opposed to individualism, and the degree to which they are democratic or totalitarian.
2. Collectivism is an ideology that views the needs of society as being more important than the needs of the individual. Collectivism translates into an advocacy for state intervention in economic activity and, in the case of communism, a totalitarian dictatorship.
3. Individualism is an ideology that is built on an emphasis of the primacy of the individual's freedoms in the political, economic, and cultural realms. Individualism translates into an advocacy for democratic ideals and free market economics.
4. Democracy and totalitarianism are at different ends of the political spectrum. In a representative democracy, citizens periodically elect individuals to represent them and political freedoms are guaranteed by a constitution. In a totalitarian state, political power is monopolized by a party, group, or individual, and basic political freedoms are denied to citizens of the state.
5. There are three broad types of economic systems: a market economy, a command economy, and a mixed economy. In a market economy, prices are free of controls and private ownership is predominant. In a command economy, prices are set by central planners, productive assets are owned by the state, and private ownership is forbidden. A mixed economy has elements of both a market economy and a command economy.
6. Differences in the structure of law between countries can have important implications for the practice of international business. The degree to which property rights are protected can vary dramatically from country to country, as can product safety and product liability legislation and the nature of contract law.

Critical Thinking and Discussion Questions

1. Free market economies stimulate greater economic growth, whereas state-directed economies stifle growth. Discuss.
2. A democratic political system is an essential condition for sustained economic progress. Discuss.
3. What is the relationship between corruption in a country (i.e., government officials taking bribes) and economic growth? Is corruption always bad?
4. You are the CEO of a company that has to choose between making a $100 million investment in Russia or Poland. Both investments promise the same long-run return, so your choice is driven by risk considerations. Assess the various risks of doing business in each of these nations. Which investment would you favor and why?

5. Read the Country Focus on Chavez's Venezuela, then answer the following questions:
   a. Under Chavez's leadership, what kind of economic system is being put in place in Venezuela? How would you characterize the political system?
   b. How do you think that Chavez's unilateral changes to contracts with foreign oil companies will impact future investment by foreigners in Venezuela?
   c. How will the high level of public corruption in Venezuela impact future growth rates?
   d. Currently Venezuela is benefiting from a boom in oil prices. What do you think might happen if oil prices retreat from their current high level?
   e. In your estimation, what is the long-run prognosis for the Venezuelan economy? Is this a country that is attractive to international businesses?

Research Task globalEDGE globaledge.msu.edu

National Differences in Political Economy

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The definition of words and political ideas can have different meanings in different contexts worldwide. In fact, the *Freedom in the World* survey evaluates the state of political rights and civil liberties around the world. Provide a description of this survey and a ranking (in terms of "freedom") of the world's leaders and laggards. What factors are taken into consideration in this survey?

Exercise 2

One way that experts analyze conditions in emerging markets is through the use of economic indicators. *The Market Potential Index* (MPI) is a yearly study conducted by the Michigan State University Center for International Business Education and Research (MSU-CIBER) to compare emerging markets on a variety of dimensions. Provide a description of the indicators used in the index. Which of the indicators would have greater importance for a company that markets laptop computers? Considering the MPI rankings, which developing countries would you advise such a company to enter first?

CLOSING CASE

Indonesia—Asia's Stumbling Giant

Indonesia is a vast country. Its 220 million people are spread out over some 17,000 islands that span an arc 3,200 miles long from Sumatra in the west to Irian Jaya in the east. It is the world's most populous Muslim nation—some 85 percent of the population count themselves as Muslims—but also one of the most ethnically diverse. More than 500 languages are spoken in the country, and separatists are active in a number of provinces. For 30 years the strong arm of President Suharto held this sprawling nation together. Suharto was a virtual dictator who was backed by the military establishment. Under his rule, the Indonesian economy grew steadily, but there was a cost. Suharto brutally repressed internal dissent. He was also famous for "crony capitalism," using his command of the political system to favor the business enterprises of his supporters and family.

In the end, Suharto was overtaken by massive debts that Indonesia had accumulated during the 1990s. In 1997, the Indonesian economy went into a tailspin. The International Monetary Fund stepped in with a $43 billion rescue package. When it was revealed that much of this money found its way into the personal coffers of Suharto and his cronies, people took to the streets in protest and he was forced to resign.

After Suharto, Indonesia moved rapidly toward a vigorous democracy, culminating in October 2004 with the inauguration of Susilo Bambang Yudhoyono, the country's

first directly elected president (he was elected to a second term in 2009). The economic front has also seen progress. Public debt as a percentage of GDP fell from close to 100 percent in 2000 to around 27 percent by 2010. Inflation declined from 12 percent annually in 2001 to 5 percent in 2010. The economy grew by between 4 and 6 percent per annum during 2001–10, and hit a high of 6.9 percent growth in 2010.

But Indonesia lags behind its Southeast Asian neighbors. Its economic growth trails that of China, Malaysia, and Thailand. Unemployment is still high at about 7 percent of the working population. Growth in labor productivity has been sluggish at best. Worse still, significant foreign capital has left the country. Sony made headlines by shutting down an audio equipment factory in 2003, and a number of apparel enterprises have left Indonesia for China and Vietnam. Between 2001 and 2004 the stock of foreign direct investment in Indonesia fell from $24.8 billion to $11.4 billion. It has since increased to more than $80 billion, largely as a result of investment in Indonesia's natural resources, including mining, oil and gas production, and forestry, but outside of extractive industries, foreign investment has remained low.

Some observers feel that Indonesian is hobbled by its poor infrastructure. Public infrastructure investment has been low for years. The road system is a mess, half of the country's population has no access to electricity, the number of brownouts is on the rise as the electricity grid ages, and over 90 percent of the population lacks access to modern sewerage facilities. The tsunami that ravaged the coast of Sumatra in late 2004 only made matters worse. Mirroring the decline in public investment has been a slump in private investment. Investment in the country's all-important oil industry fell from $3.8 billion in 1996 to just $187 million in 2002, although it has picked up since. Oil production, which peaked at 1.7 million barrels a day in the mid-1990s, declined to less than 1 million barrels a day by 2010, even though oil prices were close to record highs. Once a net exporter of oil, Indonesia is now an importer.

According to a World Bank study, business activity in Indonesia is hurt by excessive red tape. It takes 151 days on average to complete the paperwork necessary to start a business, compared to 30 days in Malaysia and just 8 days in Singapore. Another problem is the endemically high level of corruption. Transparency International, which studies corruption around the world, ranks Indonesia among the most corrupt, listing it 110 out of the 178 countries it tracked in 2010. Government bureaucrats, whose salaries are very low, inevitably demand bribes from any company that crosses their path—and Indonesia's penchant for bureaucratic red tape means a long line of officials might require bribes. Abdul Rahman Saleh, the former attorney general in Indonesia, has stated that the entire legal system, including the police and the prosecutors, is mired in corruption. The police have been known to throw the executives of foreign enterprises into jail on the flimsiest of pretexts, although some well-placed bribes can secure their release. Even though Indonesia has launched an anticorruption drive, critics claim it lacks teeth. The political elite are reportedly so corrupt that it is not in their interests to do anything meaningful to fix the system.[34]

Case Discussion Questions

1. What political factors explain Indonesia's poor economic performance? What economic factors? Are these two related?
2. Why do you think foreign firms exited Indonesia in the early 2000s? What are the implications for the country? What is required to reverse this trend?
3. Why is corruption so endemic in Indonesia? What are its consequences?
4. What are the risks facing foreign firms that do business in Indonesia? What is required to reduce these risks?

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3 Political Economy and Economic Development

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Explain what determines the level of economic development of a nation.
- **LO2** Identify the macro-political and economic changes occurring worldwide.
- **LO3** Describe how transition economies are moving toward market-based systems.
- **LO4** Explain the implications for management practice of national difference in political economy.

Revolution in Egypt

With 75 million people, Egypt is the most populous Arab state. On the face of it, during the 2000s Egypt made significant economic progress. In 2004 the government of Hosni Mubarak enacted a series of economic reforms that included trade liberalization, cuts in import tariffs, tax cuts, deregulation, and changes in investment regulations that allowed for more foreign direct investment in the Egyptian economy. As a consequence, economic growth, which had been in the 2 to 4 percent range during the early 2000s, accelerated to around 7 percent a year. Exports almost tripled, from $9 billion in 2004 to more than $25 billion by 2010. Foreign direct investment increased from $4 billion in 2004 to $11 billion in 2008, while unemployment fell from 11 percent to 8 percent.

By 2008, Egypt seemed to be displaying many of the features of other emerging economies. On Cairo's outskirts, clusters of construction cranes could be seen where gleaming new offices were being built for companies such as Microsoft, Oracle, and Vodafone. Highways were being constructed, hypermarkets were opening their doors, and sales of private cars quadrupled between 2004 and 2008. Things seemed to be improving.

However, underneath the surface, Egypt still had major economic and political problems. Inflation, long a concern in Egypt, remained high at 12.8 percent in 2010. As the global economic crisis took hold in 2008–2009, Egypt saw many of its growth drivers slow. In 2008, tourism brought some $11 billion into the country, accounting for 8.5 percent of gross domestic product, but it fell sharply in 2009 and 2010. Remittances from Egypt expatriates working overseas, which amounted to $8.5 billion in 2008, declined sharply as construction projects in the Gulf, where many of them worked, were cut back or shut down. Earnings from the Suez Canal, which stood at $5.2 billion in 2008, declined by 25 percent in 2009 as the volume of world shipping slumped in the wake of the global economic slowdown.

Egypt remains a country where there is a tremendous gap between the rich and the poor. Some 44 percent of Egyptians are classified as poor or extremely poor; the average wage is less than $100 a month. Some 2.6 million people are so destitute that their entire income cannot cover their basic food needs. These poor Egyptians lead lives that are in stark contrast to those of a wealthy elite.

The gap between rich and poor, when coupled with a sharp economic slowdown, became a toxic mix. Nominally a stable democracy with a secular government, Egypt was, in fact, an autocratic state. By 2011 President



Hosni Mubarak had been in power for over a quarter of a century. The government was highly corrupt. Mubarak and his family reportedly amassed personal fortunes amounting to billions of U.S. dollars, most of which were banked outside Egypt. Although elections were held, they were hardly free and fair. Opposition parties were kept in check by constant police harassment, their leaders often jailed on trumped up charges. In 2008 municipal elections, the regime disqualified all but a handful of members from the opposition Muslim Brotherhood, allowing the ruling National Democratic Party to run unopposed in 80 percent of districts, winning all but 1,000 of 52,000 seats. But voter turnout, at 5 percent, reflected how disenfranchised the population felt.

Given all of this, it is perhaps not surprising that in January 2011 popular discontent spilled over into the streets. Led by technologically savvy young Egyptians, who harnessed the power of the Internet and social network media such as Facebook and Twitter to organize mass demonstrations, hundreds of thousands of Egyptians poured into Cairo's Tahrir Square and demanded the resignation of the Mubarak government. There they stayed, their numbers only growing over time. For weeks Mubarak refused to step down, while the demonstrations gained momentum and Egypt's powerful military establishment stood on the sidelines. Foreign governments, including the Obama administration in the United States, long one of Egypt's most important Western allies, joined the chorus of voices calling for Mubarak to resign. In the end, his position became untenable and he stepped down on February 11, 2011. The Egyptian military took the reins of power, vowing to do so for a short time while it organized a transition to democratic elections in the fall of 2011. In March 2011, Egyptians voted on a set of proposed constitutional amendments designed to pave the way for these elections. This was the first time in six decades that Egyptians had been offered a free choice on any public issue.

Does this mean democracy is now firmly established in Egypt? Only time will tell. Many different political forces are at work in Egypt, not all of them benign. The country has no real experience with democratic institutions. Five years from now Egypt may resemble Turkey, a state whose secular model of government many Egyptians say they would like to see adopted in their country. But there is also a chance that either the military or a radicalized Islamic party might impose a more totalitarian government.[1]

Introduction

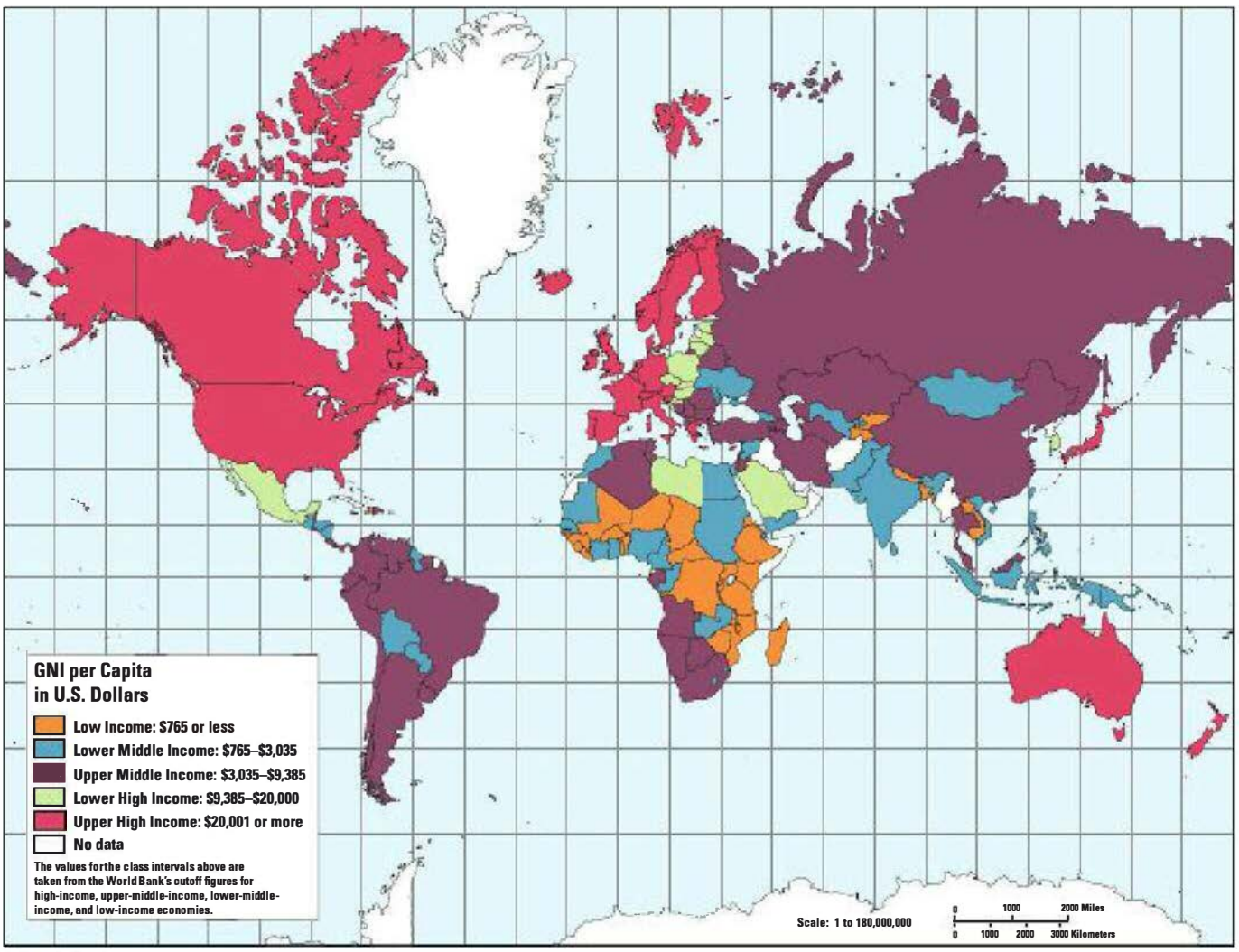
In the previous chapter we described how countries differ with regard to their political systems, economic systems, and legal systems. In this chapter, we build upon this material to explain how these differences in political economy influence the level of economic development of a nation, and thus how attractive it is as a place for doing business. We will also look at how political economy is changing around the world, and what the implications of this are for the future rate of economic development of nations and regions. The past three decades have seen a general move toward more democratic forms of government, market-based economic reforms, and adoption of legal systems that better enforce property rights. Taken together, these trends have helped to foster greater economic development around the world and have created a more favorable environment for international business. In the final section of this chapter we will pull all of this material together to explore how differences in political economy impact the benefits, costs, and risks of doing business in different nations.

The opening case, which looks at the recent largely bloodless revolution in Egypt, highlights many of the issues that we will be discussing here. Since the early 2000s, Egypt had been embracing market-based economic reforms and its economy had grown more rapidly as a result. However, although nominally a secular democracy, the country was an autocratic state ruled by the deeply corrupt regime of Hosni Mubarak, which maintained its grip on power by using the mechanisms of state power, and most notably the secret police, to stifle any opposition. In early 2011, mass demonstrations organized mostly by younger people, who harnessed the power of new communications media such as Facebook and Twitter to coordinate their protests, succeeded in ending the rule of the Mubarak regime. Egypt may now be a state in transition to a more democratic form of government, although many uncertainties remain about the eventual outcome of this process. If Egypt does succeed in becoming a secular democracy, if it continues to pursue market-based reforms, and if it works to limit corruption and protect property rights, the country may continue to climb the ladder of economic progress. This would make it an attractive nation from an international business perspective. However, there are also clear risks here. A secular democracy may be stillborn. The military or a radical Islamist party may seize power, both outcomes that might jeopardize future economic development. When considering whether to do business in a nation, international businesses are frequently confronted with such risks, and they must consider these when assessing the benefits and costs of investing in or trading with such a nation.

LO1 Differences in Economic Development

Different countries have dramatically different levels of economic development. One common measure of economic development is a country's **gross national income (GNI)** per head of population. GNI is regarded as a yardstick for the economic activity of a country; it measures the total annual income received by residents of a nation. Map 3.1 summarizes the GNI per capita of the world's nations in 2009. As can be seen, countries such as Japan, Sweden, Switzerland, and the United States are among the richest on this measure, whereas the large countries of China and India are among the poorest. Japan, for example, had a 2009 GNI per capita of $38,080, but China achieved only $3,650 and India just $1,180.[2]

GNI per person figures can be misleading because they don't consider differences in the cost of living. For example, although the 2009 GNI per capita of Switzerland at $65,430 exceeded that of the United States, which was $46,360, the higher cost of living in Switzerland meant that U.S. citizens could actually afford more goods and services than Swiss citizens. To account for differences in the cost of living, one can adjust GNI per capita by purchasing power. Referred to as a **purchasing power parity (PPP)** adjustment, it allows for a more direct comparison of living standards in different countries. The base for the adjustment is the cost of living in the United States. The PPP for



MAP 3.1

GNI per Capita, 2009



Active bartering, called the black economy, is prevalent in India.

different countries is then adjusted (up or down) depending upon whether the cost of living is lower or higher than in the United States. For example, in 2009 the GNI per capita for China was $3,650, but the PPP per capita was $6,890, suggesting that the cost of living was lower in China and that $3,650 in China would buy as much as $6,890 in the United States. Table 3.1 gives the GNI per capita measured at PPP in 2009 for a selection of countries, along with their GNI per capita and their growth rate in gross domestic product (GDP) from 1999 to 2009. Map 3.2 summarizes the GNI PPP per capita in 2009 for the nations of the world.

As can be seen, there are striking differences in the standards of living between countries. Table 3.1 suggests the average Indian citizen can afford to consume only about 7 percent of the goods and services consumed by the average U.S. citizen on a PPP basis. Given this, one might conclude that, despite having a population of 1.1 billion, India is unlikely to be a very lucrative market for the consumer products produced by many Western international businesses. However, this would be incorrect because India has a fairly wealthy middle class of close to 250 million people, despite its large number of very poor. In absolute terms the Indian economy now rivals that of Brazil and Russia (see Table 3.1).

To complicate matters, in some countries the "official" figures do not tell the entire story because large amounts of economic activity may be in the form of unrecorded cash transactions, or barter agreements. People engage in such transaction to avoid paying taxes, and although the share of total economic activity accounted for by such transactions may be small in developed economies such as the United States, in some countries, India being an example, they are reportedly very significant. Known as the black economy, estimates suggest that in India it may be around 50 percent of GDP, which implies that the Indian economy is half as big again as the figures reported in Table 3.1.[3]

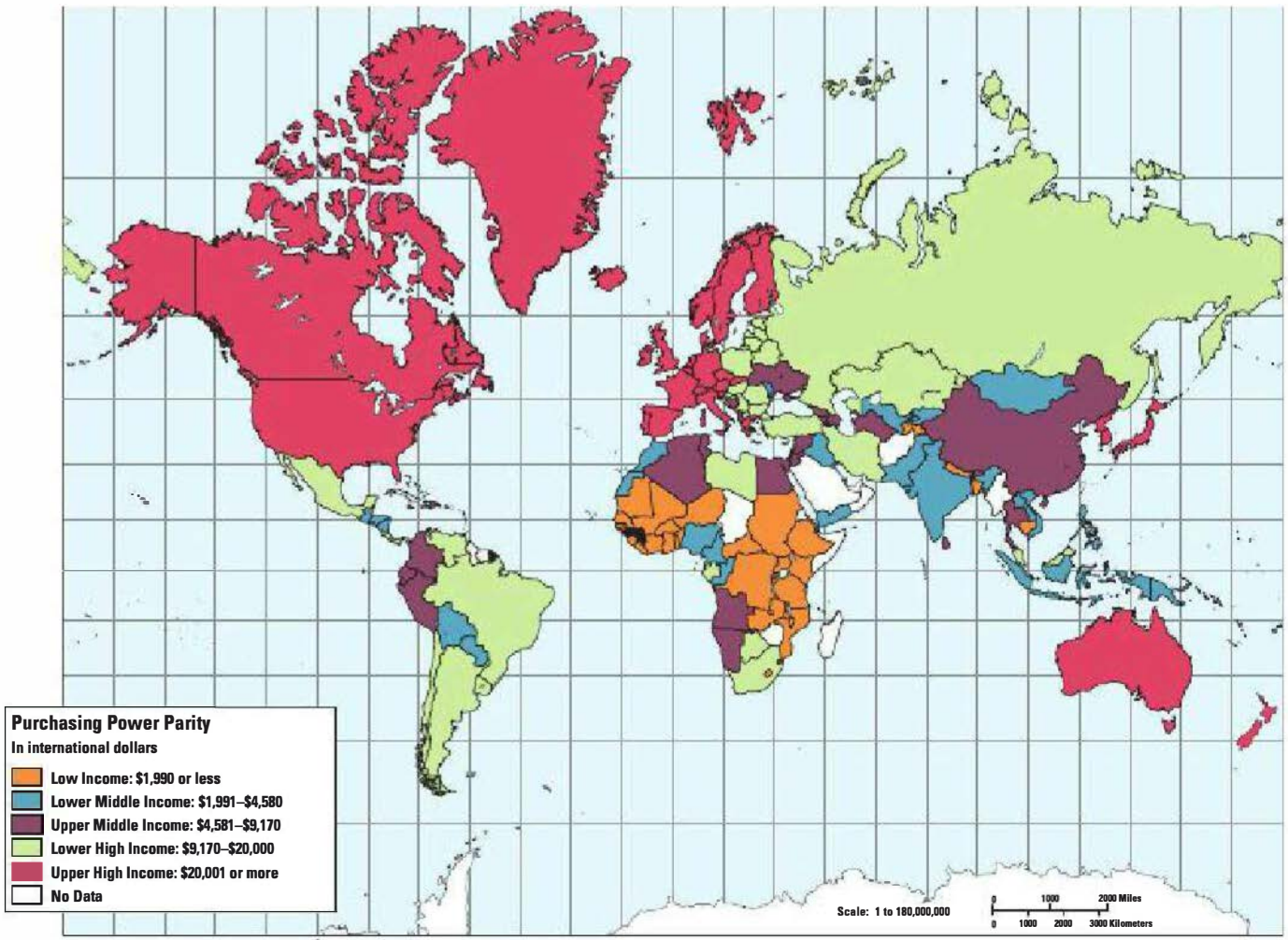
The GNI and PPP data give a static picture of development. They tell us, for example, that China is much poorer than the United States, but they do not tell us if China is closing the gap. To assess this, we have to look at the economic growth rates achieved by countries. Table 3.1 gives the rate of growth in gross domestic product (GDP) achieved by a number of countries between 1999 and 2009. Map 3.3 summarizes the growth rate in GDP from 1999 to 2009. Although countries such as China

TABLE 3.1

Economic Data for Select Countries

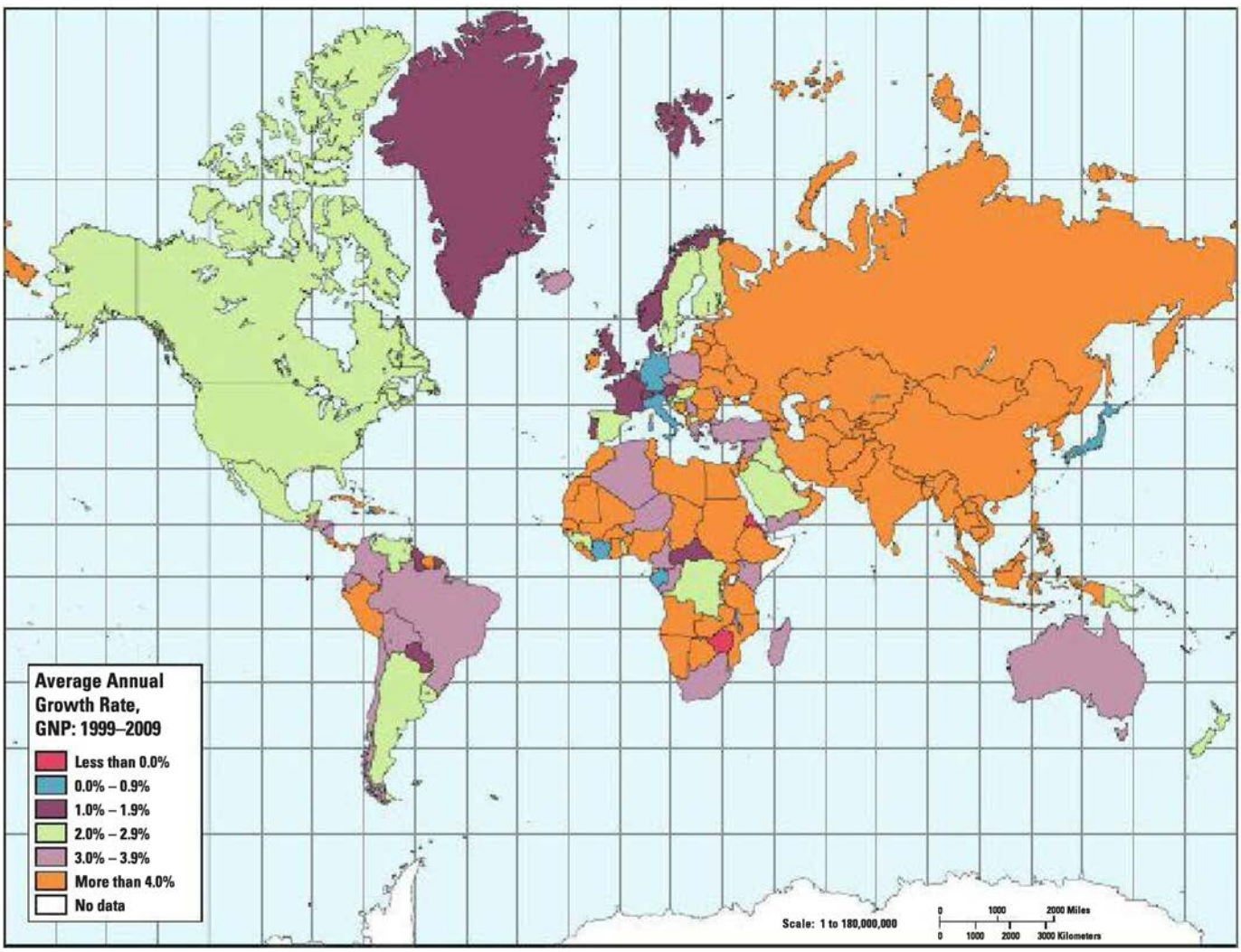
Source: World Development Indicators Online, 2011.

Country	GNI per Capita, 2009 ($)	GNI PPP per Capita, 2009 ($)	GDP Growth Rate, 1999–2009 (%)	Size of Economy GDP, 2009 ($ billions)
Brazil	8,040	10,200	3.05	1,573
China	3,650	6,890	10.04	4,985
Germany	42,450	36,780	0.95	3,330
India	1,180	3,250	7.11	1,310
Japan	38,080	33,470	0.66	5,069
Nigeria	1,190	2,070	5.61	173
Poland	12,260	18,440	4.0	430
Russia	9,340	18,350	5.56	1,231
Switzerland	65,430	46,990	1.70	491
United Kingdom	41,370	37,230	1.90	2,174
United States	46,360	45,640	2.1	14,119



MAP 3.2

GNI PPP per Capita, 2009



MAP 3.3

Growth Rate in GDP per Capital, 1999–2009

and India are currently poor, their economies are already large in absolute terms and growing more rapidly than those of many advanced nations. They are already huge markets for the products of international businesses. Provisional estimates suggest that in 2010 China overtook Japan to become the second-largest economy in the world after the United States. Indeed, if both China and the United States maintain their current economic growth rates, China will become the world's largest economy sometime between 2020 and 2025. On current trends, India too will be among the largest economies in the world. Given that potential, many international businesses are trying to gain a foothold in these markets now. Even though their current contributions to an international firm's revenues might be relatively small, their future contributions could be much larger.



Amartya Sen, Nobel Prize winner, advocates for assessing the capabilities and opportunities enjoyed by citizens of a country.

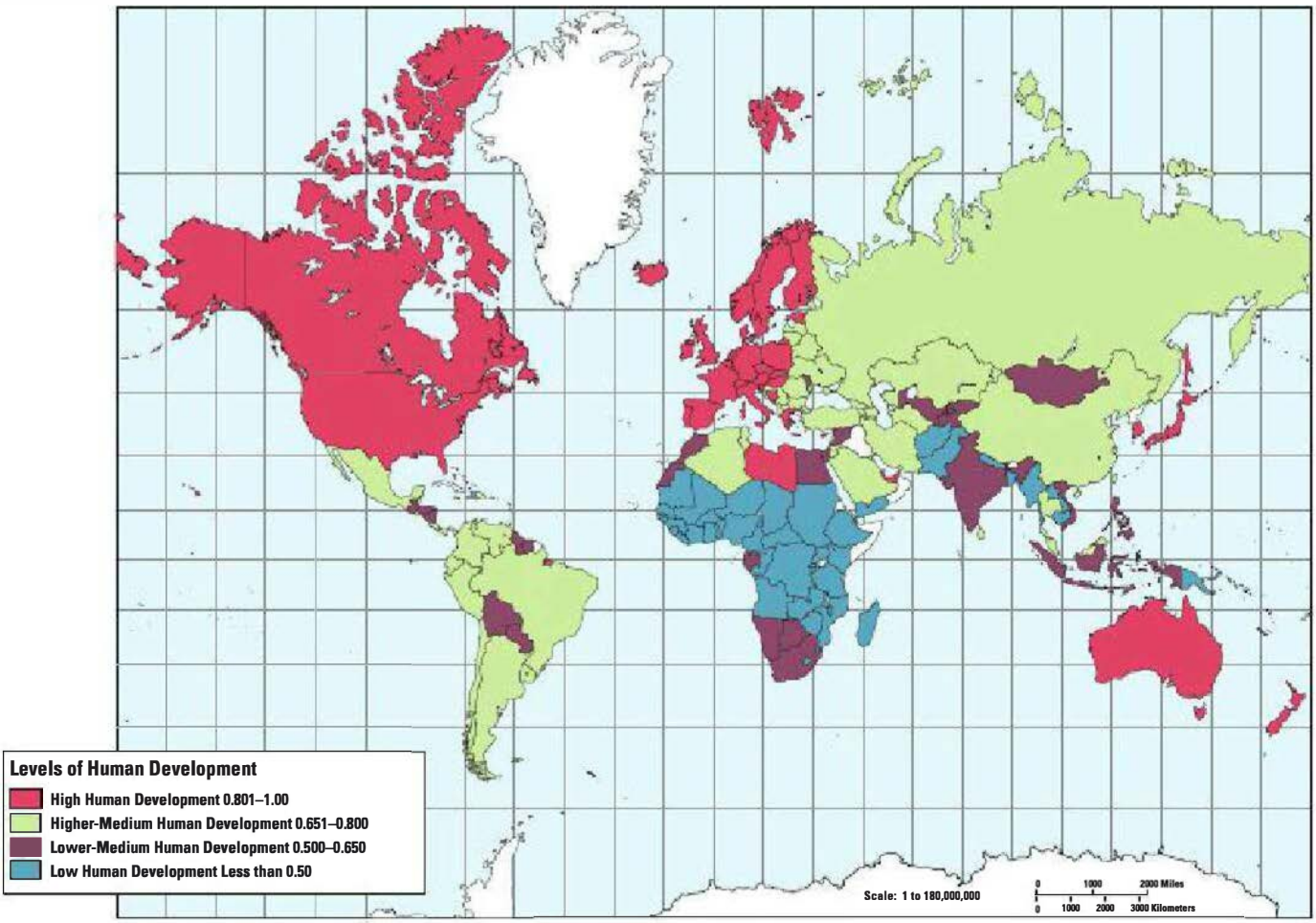
BROADER CONCEPTIONS OF DEVELOPMENT: AMARTYA SEN

The Nobel Prize-winning economist Amartya Sen has argued that development should be assessed less by material output measures such as GNI per capita and more by the capabilities and opportunities that people enjoy.[4] According to Sen, development should be seen as a process of expanding the real freedoms that people experience. Hence, development requires the removal of major impediments to freedom: poverty as well as tyranny, poor economic opportunities as well as systematic social deprivation, neglect of public facilities as well as the intolerance of repressive states. In Sen's view, development is not just an economic process, but it is a political one too, and to succeed requires the "democratization" of political communities to give citizens a voice in the important decisions made for the community. This perspective leads Sen to emphasize basic health care, especially for children, and basic education, especially for women. Not only are these factors desirable for their instrumental value in helping to achieve higher income levels, but they are also beneficial in their own right. People cannot develop their capabilities if they are chronically ill or woefully ignorant.

Sen's influential thesis has been picked up by the United Nations, which has developed the **Human Development Index (HDI)** to measure the quality of human life in different nations. The HDI is based on three measures: life expectancy at birth (a function of health care), educational attainment (measured by a combination of the adult literacy rate and enrollment in primary, secondary, and tertiary education), and whether average incomes, based on PPP estimates, are sufficient to meet the basic needs of life in a country (adequate food, shelter, and health care). As such, the HDI comes much closer to Sen's conception of how development should be measured than narrow economic measures such as GNI per capita—although Sen's thesis suggests that political freedoms should also be included in the index, and they are not. The HDI is scaled from 0 to 1. Countries scoring less than 0.5 are classified as having low human development (the quality of life is poor); those scoring from 0.5 to 0.8 are classified as having medium human development; and those that score above 0.8 are classified as having high human development. Map 3.4 summarizes the HDI scores for 2010.

Political Economy and Economic Progress

It is often argued that a country's economic development is a function of its economic and political systems. What then is the nature of the relationship between political economy and economic progress? Despite the long debate over this question among academics and policy makers, it is not possible to give an unambiguous answer. However, it is possible to untangle the main threads of the arguments and make a few generalizations as to the nature of the relationship between political economy and economic progress.



MAP 3.4

Human Development Index, 2010

INNOVATION AND ENTREPRENEURSHIP ARE THE ENGINES OF GROWTH

There is substantial agreement among economists that innovation and entrepreneurial activity are the engines of long-run economic growth.[5] Those who make this argument define **innovation** broadly to include not just new products but also new processes, new organizations, new management practices, and new strategies. Thus, the Toys "R" Us strategy of establishing large warehouse-style toy stores and then engaging in heavy advertising and price discounting to sell the merchandise can be classified as an innovation because it was the first company to pursue this strategy. Innovation and entrepreneurial activity help to increase economic activity by creating new products and markets that did not previously exist. Moreover, innovations in production and business processes lead to an increase in the productivity of labor and capital, which further boosts economic growth rates.[6]

Innovation is also seen as the product of entrepreneurial activity. Often, **entrepreneurs** first commercialize innovative new products and processes, and entrepreneurial activity provides much of the dynamism in an economy. For example, the U.S. economy has benefited greatly from a high level of entrepreneurial activity, which has resulted in rapid innovation in products and process. Firms such as Google, Cisco Systems, Dell, Microsoft, and Oracle were all founded by entrepreneurial individuals to exploit new technology. All of these firms created significant economic value and boosted productivity by helping to commercialize innovations in products and processes. Thus, one can conclude that if a country's economy is to sustain long-run economic growth, the business environment must be conducive to the consistent production of product and process innovations and to entrepreneurial activity.

INNOVATION AND ENTREPRENEURSHIP REQUIRE A MARKET ECONOMY

This leads logically to a further question: What is required for the business environment of a country to be conducive to innovation and entrepreneurial activity? Those who have considered this issue highlight the advantages of a market economy.[7] It has been argued that the economic freedom associated with a market economy creates greater incentives for innovation and entrepreneurship than either a planned or a mixed economy. In a market economy, any individual who has an innovative idea is free to try to make money out of that idea by starting a business (by engaging in entrepreneurial activity). Similarly, existing businesses are free to improve their operations through innovation. To the extent that they are successful, both individual entrepreneurs and established businesses can reap rewards in the form of high profits. Thus, market economies contain enormous incentives to develop innovations.

In a planned economy, the state owns all means of production. Consequently, entrepreneurial individuals have few economic incentives to develop valuable new innovations, because it is the state, rather than the individual, that captures most of the gains. The lack of economic freedom and incentives for innovation was probably a main factor in the economic stagnation of many former communist states and led ultimately to their collapse at the end of the 1980s. Similar stagnation occurred in many mixed economies in those sectors where the state had a monopoly (such as coal mining and telecommunications in Great Britain). This stagnation provided the impetus for the widespread privatization of state-owned enterprises that we witnessed in many mixed economies during the mid-1980s and that is still going on today (*privatization* refers to the process of selling state-owned enterprises to private investors).

A study of 102 countries over a 20-year period provided evidence of a strong relationship between economic freedom (as provided by a market economy) and economic growth.[8] The study found that the more economic freedom a country had between 1975 and 1995, the more economic growth it achieved and the richer its citizens became. The

six countries that had persistently high ratings of economic freedom from 1975 to 1995 (Hong Kong, Switzerland, Singapore, the United States, Canada, and Germany) were also all in the top 10 in terms of economic growth rates. In contrast, no country with persistently low economic freedom achieved a respectable growth rate. In the 16 countries for which the index of economic freedom declined the most during 1975 to 1995, gross domestic product fell at an annual rate of 0.6 percent.

INNOVATION AND ENTREPRENEURSHIP REQUIRE STRONG PROPERTY RIGHTS

Strong legal protection of property rights is another requirement for a business environment to be conducive to innovation, entrepreneurial activity, and hence economic growth.[9] Both individuals and businesses must be given the opportunity to profit from innovative ideas. Without strong property rights protection, businesses and individuals run the risk that the profits from their innovative efforts will be expropriated, either by criminal elements or by the state. The state can expropriate the profits from innovation through legal means, such as excessive taxation, or through illegal means, such as demands from state bureaucrats for kickbacks in return for granting an individual or firm a license to do business in a certain area (i.e., corruption). According to the Nobel Prize-winning economist Douglass North, throughout history many governments have displayed a tendency to engage in such behavior. Inadequately enforced property rights reduce the incentives for innovation and entrepreneurial activity—because the profits from such activity are "stolen"—and hence reduce the rate of economic growth.

The influential Peruvian development economist Hernando de Soto has argued that much of the developing world will fail to reap the benefits of capitalism until property rights are better defined and protected.[10] De Soto's arguments are interesting because he says the key problem is not the risk of expropriation but the chronic inability of property owners to establish legal title to the property they own. As an example of the scale of the problem, he cites the situation in Haiti, where individuals must take 176 steps over 19 years to own land legally. Because most property in poor countries is informally "owned," the absence of legal proof of ownership means that property holders cannot convert their assets into capital, which could then be used to finance business ventures. Banks will not lend money to the poor to start businesses because the poor possess no proof that they own property, such as farmland, that can be used as collateral for a loan. By de Soto's calculations, the total value of real estate held by the poor in Third World and former communist states amounted to more than $9.3 trillion in 2000. If those assets could be converted into capital, the result could be an economic revolution that would allow the poor to bootstrap their way out of poverty. Interestingly enough, the Chinese seem to have taken de Soto's arguments to heart. Despite still being nominally a communist country, in October 2007 the government passed a law that gave private property owners the same rights as the state, and significantly improved the rights of urban and rural landowners to the land that they use (see the accompanying Country Focus for details).

THE REQUIRED POLITICAL SYSTEM

Much debate surrounds which kind of political system best achieves a functioning market economy with strong protection for property rights.[12] People in the West tend to associate a representative democracy with a market economic system, strong property rights protection, and economic progress. Building on this, we tend to argue that democracy is good for growth. However, some totalitarian regimes have fostered a market economy and strong property rights protection and have experienced rapid economic growth. Five of the fastest-growing economies of the past 30 years—China, South Korea, Taiwan, Singapore, and Hong Kong—had one thing in common at the



COUNTRY FOCUS

Emerging Property Rights in China

On October 1, 2007, a new property law took effect in China, granting rural and urban landholders far more secure property rights. The law was a much-needed response to how China's economy has changed over the past 30 years as it transitions from a centrally planned system to a dynamic market-based economy where two-thirds of economic activity is in the hands of private enterprises.

Although all land in China still technically belongs to the state—an ideological necessity in a country where the government still claims to be guided by Marxism—urban landholders had been granted 40- to 70-year leases to use the land, while rural farmers had 30-year leases. However, the lack of legal title meant that landholders were at the whim of the state. Large-scale appropriation of rural land for housing and factory construction has rendered millions of farmers landless. Many were given little or no compensation, and they drifted to the cities where they added to a growing underclass. In both urban and rural areas, property and land disputes had become a leading cause of social unrest. According to government sources, in 2006 there were about 23,000 "mass incidents" of social unrest in China, many related to disputes over property rights.

The new law, which was 14 years in gestation due to a rearguard action fought by left-wing Communist Party activists who objected to it on ideological grounds, gives urban and rural land users the right to automatic renewal of their leases after the expiration of the 30- to 70-year terms. In addition, the law requires that land users be fairly compensated if the land is required for other purposes, and it gives individuals the same legal protection for their property as the state. Taken together with a 2004 change in China's constitution, which stated that private property "was not to be encroached upon," the new law significantly strengthens property rights in China.

Nevertheless, the law has its limitations; most notably it still falls short of giving peasants marketable ownership rights to the land they farm. If they could sell their land, tens of millions of underemployed farmers might find more productive work elsewhere. Those that stayed could acquire bigger land holdings that could be used more efficiently. Also, farmers might be able to use their land holdings as security against which they could borrow funds for investments to boost productivity.[11]

start of their economic growth: undemocratic governments. At the same time, countries with stable democratic governments, such as India, experienced sluggish economic growth for long periods. In 1992, Lee Kuan Yew, Singapore's leader for many years, told an audience, "I do not believe that democracy necessarily leads to development. I believe that a country needs to develop discipline more than democracy. The exuberance of democracy leads to undisciplined and disorderly conduct which is inimical to development."[13]

However, those who argue for the value of a totalitarian regime miss an important point: If dictators made countries rich, then much of Africa, Asia, and Latin America should have been growing rapidly during 1960 to 1990, and this was not the case. Only a totalitarian regime that is committed to a market system and strong protection of property rights is capable of promoting economic growth. Also, there is no guarantee that a dictatorship will continue to pursue such progressive policies. Dictators are rarely benevolent. Many are tempted to use the apparatus of the state to further their own private ends, violating property rights and stalling economic growth (as may have occurred in Egypt—see the opening case). Given this, it seems likely that democratic regimes are far more conducive to long-term economic growth than are dictatorships, even benevolent ones. Only in a well-functioning, mature democracy are property rights truly secure.[14] Nor should we forget Amartya Sen's arguments reviewed earlier. Totalitarian states, by limiting human freedom, also suppress human development and therefore are detrimental to progress.

ECONOMIC PROGRESS BEGETS DEMOCRACY

While it is possible to argue that democracy is not a necessary precondition for a free market economy in which property rights are protected, subsequent economic growth often leads to establishment of a democratic regime. Several of the fastest-growing Asian economies adopted more democratic governments during the past three decades, including South Korea and Taiwan. Thus, although democracy may not always be the cause of initial economic progress, it seems to be one consequence of that progress.

A strong belief that economic progress leads to adoption of a democratic regime underlies the fairly permissive attitude that many Western governments have adopted toward human rights violations in China. Although China has a totalitarian government in which human rights are violated, many Western countries have been hesitant to criticize the country too much for fear that this might hamper the country's march toward a free market system. The belief is that once China has a free market system, greater individual freedoms and democracy will follow. Whether this optimistic vision comes to pass remains to be seen.

GEOGRAPHY, EDUCATION, AND ECONOMIC DEVELOPMENT

While a country's political and economic systems are probably the big engine driving its rate of economic development, other factors are also important. One that has received attention recently is geography.[15] But the belief that geography can influence economic policy, and hence economic growth rates, goes back to Adam Smith. The influential Harvard University economist Jeffrey Sachs argues

> that throughout history, coastal states, with their long engagements in international trade, have been more supportive of market institutions than landlocked states, which have tended to organize themselves as hierarchical (and often military) societies. Mountainous states, as a result of physical isolation, have often neglected market-based trade. Temperate climes have generally supported higher densities of population and thus a more extensive division of labor than tropical regions.[16]

Sachs's point is that by virtue of favorable geography, certain societies are more likely to engage in trade than others and are thus more likely to be open to and develop market-based economic systems, which in turn promotes faster economic growth. He also argues that, irrespective of the economic and political institutions a country adopts, adverse geographical conditions, such as the high rate of disease, poor soils, and hostile climate that afflict many tropical countries, can have a negative impact on development. Together with colleagues at Harvard's Institute for International Development, Sachs tested for the impact of geography on a country's economic growth rate between 1965 and 1990. He found that landlocked countries grew more slowly than coastal economies and that being entirely landlocked reduced a country's growth rate by roughly 0.7 percent per year. He also found that tropical countries grew 1.3 percent more slowly each year than countries in the temperate zone.

Education emerges as another important determinant of economic development (a point that Amartya Sen emphasizes). The general assertion is that nations that invest more in education will have higher growth rates because an educated population is a more productive population. Anecdotal comparisons suggest this is true. In 1960, Pakistanis and South Koreans were on equal footing economically. However, just 30 percent of Pakistani children were enrolled in primary schools, while 94 percent of South Koreans were. By the mid-1980s, South Korea's GNP per person was three times that of Pakistan.[17] A survey of 14 statistical studies that looked at the relationship between a country's investment in education and its subsequent growth rates concluded investment in education did have a positive and statistically significant impact on a country's rate of economic growth.[18] Similarly, the work by Sachs discussed above suggests that investments in education help explain why some countries in Southeast Asia,

such as Indonesia, Malaysia, and Singapore, have been able to overcome the disadvantages associated with their tropical geography and grow far more rapidly than tropical nations in Africa and Latin America.

States in Transition

LO2

The political economy of many of the world's nation-states has changed radically since the late 1980s. Two trends have been evident. First, during the late 1980s and early 1990s, a wave of democratic revolutions swept the world. Totalitarian governments collapsed and were replaced by democratically elected governments that were typically more committed to free market capitalism than their predecessors had been. Second, there has been a strong move away from centrally planned and mixed economies and toward a more free market economic model. We shall look first at the spread of democracy and then turn our attention to the spread of free market economies.

THE SPREAD OF DEMOCRACY

One notable development of the past 20 years has been the spread of democracy (and, by extension, the decline of totalitarianism). Map 3.5 reports on the extent of totalitarianism in the world as determined by Freedom House.[19] This map charts political freedom in 2010, grouping countries into three broad groupings, free, partly free, and not free. In "free" countries, citizens enjoy a high degree of political and civil freedoms. "Partly free" countries are characterized by some restrictions on political rights and civil liberties, often in the context of corruption, weak rule of law, ethnic strife, or civil war. In "not free" countries, the political process is tightly controlled and basic freedoms are denied.

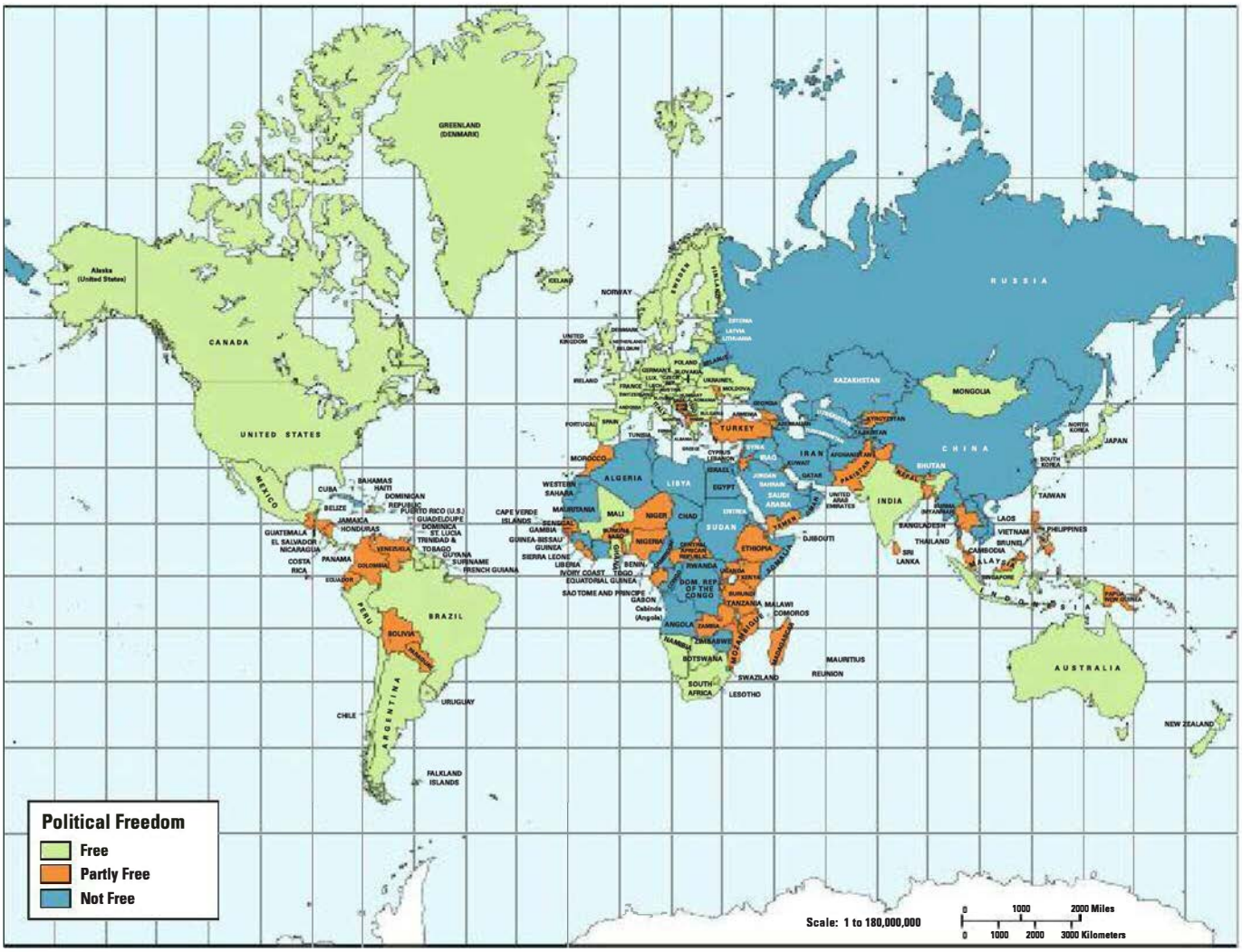
Freedom House classified some 87 countries as free in 2010, accounting for some 45 percent of the world's nations. These countries respect a broad range of political rights. Another 60 countries accounting for 31 percent of the world's nations were classified as partly free, while 47 countries representing some 24 percent of the world's nations were classified as not free. The number of democracies in the world has increased from 69 nations in 1987 to 115 in 2010, slightly below the 2006 total of 123. But not all democracies are free, according to Freedom House, because some democracies still restrict certain political and civil liberties. For example, Russia was rated "not free." According to Freedom House,

> Russia's step backwards into the Not Free category is the culmination of a growing trend . . . to concentrate political authority, harass and intimidate the media, and politicize the country's law-enforcement system.[20]

Similarly, Freedom House argues that democracy is being restricted in Venezuela under the leadership of Hugo Chavez.

Many of the newer democracies are to be found in Eastern Europe and Latin America, although there also have been notable gains in Africa during this time, such as in South Africa. Entrants into the ranks of the world's democracies include Mexico, which held its first fully free and fair presidential election in 2000 after free and fair parliamentary and state elections in 1997 and 1998; Senegal, where free and fair presidential elections led to a peaceful transfer of power; Yugoslavia, where a democratic election took place despite attempted fraud by the incumbent; and Ukraine, where popular unrest following widespread ballot fraud in the 2004 presidential election resulted in a second election, the victory of a reform candidate, and a marked improvement in civil liberties.

Three main reasons account for the spread of democracy.[21] First, many totalitarian regimes failed to deliver economic progress to the vast bulk of their populations. The collapse of communism in Eastern Europe, for example, was precipitated by the growing gulf between the vibrant and wealthy economies of the West and the stagnant economies of the Communist East. In looking for alternatives to the socialist model, the populations of



MAP 3.5

Political Freedom in 2010

Source: The Freedom House Survey Team, "Freedom in the World: 2011," www.freedomhouse.org.

these countries could not have failed to notice that most of the world's strongest economies were governed by representative democracies. Today, the economic success of many of the newer democracies, such as Poland and the Czech Republic in the former Communist bloc, the Philippines and Taiwan in Asia, and Chile in Latin America, has strengthened the case for democracy as a key component of successful economic advancement.



Many Egyptian protests in 2011 were organized through social networking technology.

Second, new information and communication technologies, including satellite television, fax machines, desktop publishing, and, most important, the Internet, have reduced a state's ability to control access to uncensored information. These technologies have created new conduits for the spread of democratic ideals and information from free societies. Today, the Internet is allowing democratic ideals to penetrate closed societies as never before.[22] The recent demonstrations that led to the overthrow of the Egyptian government were organized by young people who utilized Facebook and Twitter to reach large numbers of people very quickly and coordinate their actions.

Third, in many countries the economic advances of the past quarter century have led to the emergence of increasingly prosperous middle and working classes who have pushed for democratic reforms. This was certainly a factor in the democratic transformation of South Korea. Entrepreneurs and other business leaders, eager to protect their property rights and ensure the dispassionate enforcement of contracts, are another force pressing for more accountable and open government.

Despite this, it would be naive to conclude that the global spread of democracy will continue unchallenged. Democracy is still rare in large parts of the world. In sub-Saharan Africa in 2010, only 9 countries were considered free, 22 were partly free, and 17 were not free. Among the post-Communist countries in Eastern and Central Europe and the former Soviet Union, 8 are still not electoral democracies and Freedom House classifies only 13 of these states as free (primarily in Eastern Europe). And there is only 1 free state among the 17 nations of the Middle East and North Africa—although it remains to be seen how the wave of unrest that spread across the Middle East during early 2011 will change this. Certainly there is now hope that in both Tunisia and Egypt, where governments were removed by popular unrest, new more democratic regimes might take hold.

THE NEW WORLD ORDER AND GLOBAL TERRORISM

The end of the Cold War and the "new world order" that followed the collapse of communism in Eastern Europe and the former Soviet Union, taken together with the demise of many authoritarian regimes in Latin America, have given rise to intense speculation about the future shape of global geopolitics. Author Francis Fukuyama has argued, "We may be witnessing . . . the end of history as such: that is, the end point of mankind's ideological evolution and the universalization of Western liberal democracy as the final form of human government."[23] Fukuyama goes on to say that the war of ideas may be at an end and that liberal democracy has triumphed.

Others question Fukuyama's vision of a more harmonious world dominated by a universal civilization characterized by democratic regimes and free market capitalism. In a controversial book, the influential political scientist Samuel Huntington argues there is

no "universal" civilization based on widespread acceptance of Western liberal democratic ideals.[24] Huntington maintains that while many societies may be modernizing—they are adopting the material paraphernalia of the modern world, from automobiles to Coca-Cola and MTV—they are not becoming more Western. On the contrary, Huntington theorizes that modernization in non-Western societies can result in a retreat toward the traditional, such as the resurgence of Islam in many traditionally Muslim societies. He writes,

> The Islamic resurgence is both a product of and an effort to come to grips with modernization. Its underlying causes are those generally responsible for indigenization trends in non-Western societies: urbanization, social mobilization, higher levels of literacy and education, intensified communication and media consumption, and expanded interaction with Western and other cultures. These developments undermine traditional village and clan ties and create alienation and an identity crisis. Islamist symbols, commitments, and beliefs meet these psychological needs, and Islamist welfare organizations, the social, cultural, and economic needs of Muslims caught in the process of modernization. Muslims feel a need to return to Islamic ideas, practices, and institutions to provide the compass and the motor of modernization.[25]

Thus, the rise of Islamic fundamentalism is portrayed as a response to the alienation produced by modernization.

In contrast to Fukuyama, Huntington sees a world that is split into different civilizations, each of which has its own value systems and ideology. In addition to Western civilization, Huntington predicts the emergence of strong Islamic and Sinic (Chinese) civilizations, as well as civilizations based on Japan, Africa, Latin America, Eastern Orthodox Christianity (Russian), and Hinduism (Indian). Huntington also sees the civilizations as headed for conflict, particularly along the "fault lines" that separate them, such as Bosnia (where Muslims and Orthodox Christians have clashed), Kashmir (where Muslims and Hindus clash), and the Sudan (where a bloody war between Christians and Muslims has persisted for decades). Huntington predicts conflict between the West and Islam and between the West and China. He bases his predictions on an analysis of the different value systems and ideology of these civilizations, which in his view tend to bring them into conflict with each other. While some commentators originally dismissed Huntington's thesis, in the aftermath of the terrorist attacks on the United States on September 11, 2001, Huntington's views received new attention.

If Huntington's views are even partly correct, they have important implications for international business. They suggest many countries may be increasingly difficult places in which to do business, either because they are shot through with violent conflicts or because they are part of a civilization that is in conflict with an enterprise's home country. Huntington's views are speculative and controversial. More likely than his predictions coming to pass is the evolution of a global political system that is positioned somewhere between Fukuyama's universal global civilization based on liberal democratic ideals and Huntington's vision of a fractured world. That would still be a world, however, in which geopolitical forces periodically limit the ability of business enterprises to operate in certain foreign countries.

In Huntington's thesis, global terrorism is a product of the tension between civilizations and the clash of value systems and ideology. Others point to terrorism's roots in long-standing conflicts that seem to defy political resolution, the Palestinian, Kashmir, and Northern Ireland conflicts being obvious examples. It should also be noted that a substantial amount of terrorist activity in some parts of the world, such as Colombia, has been interwoven with the illegal drug trade. The attacks of September 11, 2001, created the impression that global terror is on the rise, although accurate statistics on this are hard to come by. We do know that, according to data from the U.S. Department of State, in 2009 there were some 10,999 terrorist attacks worldwide, about the same as in 2005 and a decline from 14,507 in 2007. The hot spots around the world include South Asia, with 44 percent of the total, and the Near East, with 30 percent. Not surprisingly perhaps, Afghanistan, Pakistan, Iraq, and Somalia were the four countries that accounted

for the largest amount of terrorist attacks. As former U.S. Secretary of State Colin Powell has maintained, terrorism represents one of the major threats to world peace and economic progress in the twenty-first century.[26]

THE SPREAD OF MARKET-BASED SYSTEMS

Paralleling the spread of democracy since the 1980s has been the transformation from centrally planned command economies to market-based economies. More than 30 countries that were in the former Soviet Union or the Eastern European Communist bloc have changed their economic systems. A complete list of countries where change is now occurring also would include Asian states such as China and Vietnam, as well as African countries such as Angola, Ethiopia, and Mozambique.[27] There has been a similar shift away from a mixed economy. Many states in Asia, Latin America, and Western Europe have sold state-owned businesses to private investors (privatization) and deregulated their economies to promote greater competition.

The rationale for economic transformation has been the same the world over. In general, command and mixed economies failed to deliver the kind of sustained economic performance that was achieved by countries adopting market-based systems, such as the United States, Switzerland, Hong Kong, and Taiwan. As a consequence, even more states have gravitated toward the market-based model. Map 3.6, based on data from the Heritage Foundation, a politically conservative U.S. research foundation, gives some idea of the degree to which the world has shifted toward market-based economic systems. The Heritage Foundation's index of economic freedom is based on 10 indicators, including the extent to which the government intervenes in the economy, trade policy, the degree to which property rights are protected, foreign investment regulations, and taxation rules. A country can score between 1 (most free) and 5 (least free) on each of these indicators. The lower a country's average score across all 10 indicators, the more closely its economy represents the pure market model. According to the 2011 index, which is summarized in Map 3.6, the world's freest economies are (in rank order) Hong Kong, Singapore, Australia, New Zealand, Switzerland, Canada, Ireland, Denmark, United States, and Bahrain. Japan came in at 20, Mexico at 48, France at 64, Brazil, 113; India, 124; China 135; and Russia, 143. The economies of Cuba, Iran, Venezuela, and North Korea are to be found near the bottom of the rankings.[28]

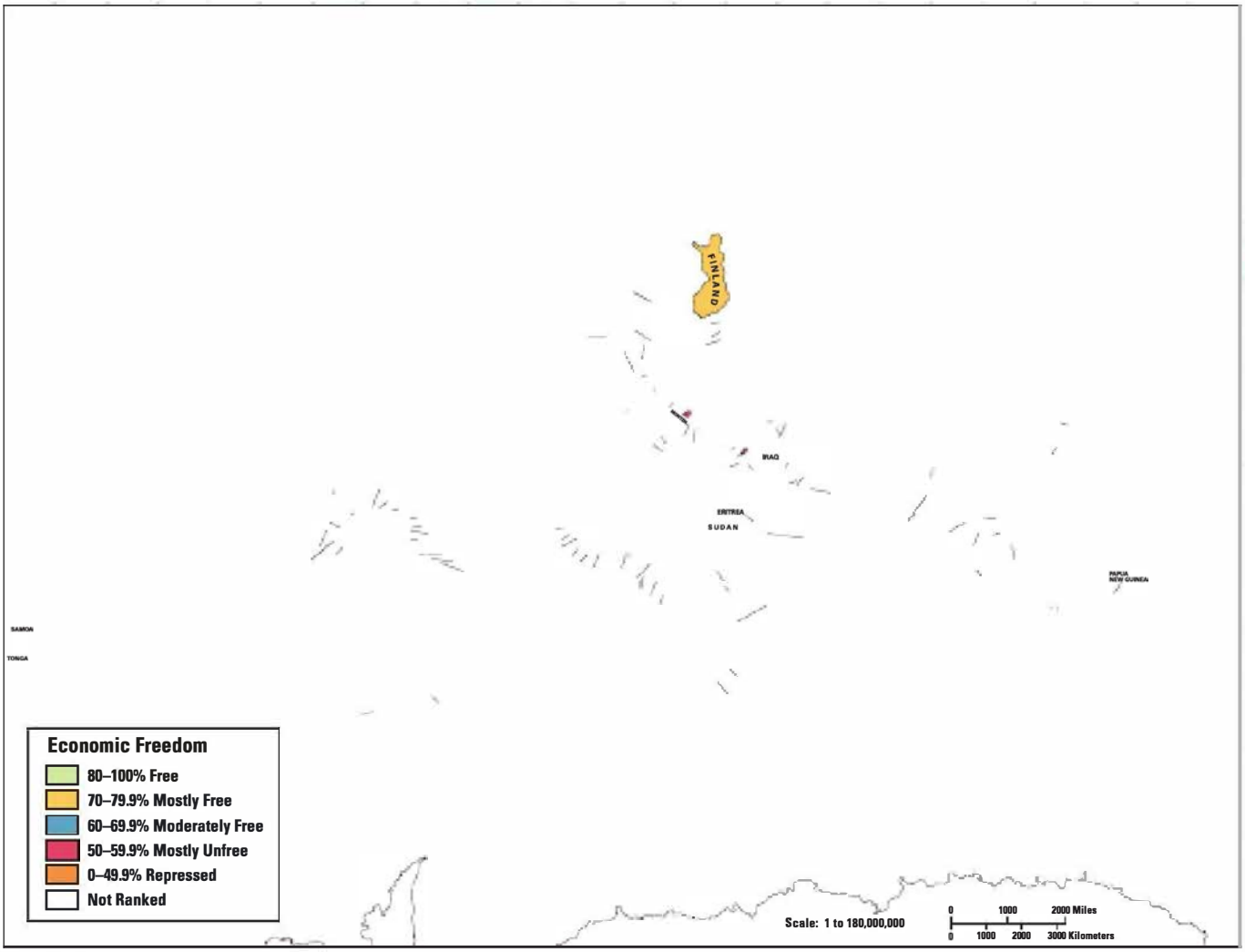
Economic freedom does not necessarily equate with political freedom, as detailed in Map 3.6. For example, the two top states in the Heritage Foundation index, Hong Kong and Singapore, cannot be classified as politically free. Hong Kong was reabsorbed into Communist China in 1997, and the first thing Beijing did was shut down Hong Kong's freely elected legislature. Singapore is ranked as only partly free on Freedom House's index of political freedom due to practices such as widespread press censorship.

The Nature of Economic Transformation LO3

The shift toward a market-based economic system often entails a number of steps: deregulation, privatization, and creation of a legal system to safeguard property rights.[29]

DEREGULATION

Deregulation involves removing legal restrictions to the free play of markets, the establishment of private enterprises, and the manner in which private enterprises operate. Before the collapse of communism, the governments in most command economies exercised tight control over prices and output, setting both through detailed state planning. They also prohibited private enterprises from operating in most sectors of the economy, severely restricted direct investment by foreign enterprises, and limited international trade. Deregulation in these cases involved removing price controls, thereby allowing prices to be set by the interplay between demand and supply; abolishing laws regulating



MAP 3.6

Distribution of Economic Freedom, 2011

Source: *2011 Index of Economic Freedom* (Washington, DC: Heritage Foundation, 2011). Reprinted with permission of The Heritage Foundation, www.heritage.org.

the establishment and operation of private enterprises; and relaxing or removing restrictions on direct investment by foreign enterprises and international trade.

In mixed economies, the role of the state was more limited; but here too, in certain sectors the state set prices, owned businesses, limited private enterprise, restricted investment by foreigners, and restricted international trade. For these countries, deregulation has involved the same kind of initiatives that we have seen in former command economies, although the transformation has been easier because these countries often had a vibrant private sector. India is an example of a country that has substantially deregulated its economy over the past two decades (see the accompanying Country Focus on India).

PRIVATIZATION

Hand in hand with deregulation has come a sharp increase in privatization. Privatization, as we discussed earlier in this chapter, transfers the ownership of state property into the hands of private individuals, frequently by the sale of state assets through an auction.[30] Privatization is seen as a way to stimulate gains in economic efficiency by giving new private owners a powerful incentive—the reward of greater profits—to search for increases in productivity, to enter new markets, and to exit losing ones.[31]

The privatization movement started in Great Britain in the early 1980s when then Prime Minister Margaret Thatcher started to sell state-owned assets such as the British telephone company, British Telecom (BT). In a pattern that has been repeated around the world, this sale was linked with the deregulation of the British telecommunications industry. By allowing other firms to compete head-to-head with BT, deregulation ensured that privatization did not simply replace a state-owned monopoly with a private monopoly. Since the 1980s, privatization has become a worldwide phenomenon. More than 8,000 acts of privatization were completed around the world between 1995 and 1999.[32] Some of the most dramatic privatization programs occurred in the economies of the former Soviet Union and its Eastern European satellite states. In the Czech Republic, for example, three-quarters of all state-owned enterprises were privatized between 1989 and 1996, helping to push the share of gross domestic product accounted for by the private sector up from 11 percent in 1989 to 60 percent in 1995.[33]

As privatization has proceeded around the world, it has become clear that simply selling state-owned assets to private investors is not enough to guarantee economic growth. Studies of privatization in central Europe have shown that the process often fails to deliver predicted benefits if the newly privatized firms continue to receive subsidies from the state and if they are protected from foreign competition by barriers to international trade and foreign direct investment.[34] In such cases, the newly privatized firms are sheltered from competition and continue acting like state monopolies. When these circumstances prevail, the newly privatized entities often have little incentive to restructure their operations to become more efficient. For privatization to work, it must also be accompanied by a more general deregulation and opening of the economy. Thus, when Brazil decided to privatize the state-owned telephone monopoly, Telebras Brazil, the government also split the company into four independent units that were to compete with each other and removed barriers to foreign direct investment in telecommunications services. This action ensured that the newly privatized entities would face significant competition and thus would have to improve their operating efficiency to survive.

The ownership structure of newly privatized firms also is important.[35] Many former command economies, for example, lack the legal regulations regarding corporate governance that are found in advanced Western economies. In advanced market economies, boards of directors are appointed by shareholders to make sure managers consider the interests of shareholders when making decisions and try to manage the firm in a manner that is consistent with maximizing the wealth of shareholders. However, some former Communist states still lack laws requiring corporations to establish effective boards. In such cases, managers with a small ownership stake can often gain control over the newly privatized entity and run it for their own benefit, while ignoring the interests of other

India's Economic Transformation

After gaining independence from Britain in 1947, India adopted a democratic system of government. The economic system that developed in India after 1947 was a mixed economy characterized by a large number of state-owned enterprises, centralized planning, and subsidies. This system constrained the growth of the private sector. Private companies could expand only with government permission. It could take years to get permission to diversify into a new product. Much of heavy industry, such as auto, chemical, and steel production, was reserved for state-owned enterprises. Production quotas and high tariffs on imports also stunted the development of a healthy private sector, as did labor laws that made it difficult to fire employees.

By the early 1990s, it was clear this system was incapable of delivering the kind of economic progress that many Southeastern Asian nations had started to enjoy. In 1994, India's economy was still smaller than Belgium's, despite having a population of 950 million. Its GDP per capita was a paltry $310; less than half the population could read; only 6 million had access to telephones; only 14 percent had access to clean sanitation; the World Bank estimated that some 40 percent of the world's desperately poor lived in India; and only 2.3 percent of the population had a household income in excess of $2,484.

The lack of progress led the government to embark on an ambitious economic reform program. Starting in 1991, much of the industrial licensing system was dismantled, and several areas once closed to the private sector were opened, including electricity generation, parts of the oil industry, steelmaking, air transport, and some areas of the telecommunications industry. Investment by foreign enterprises, formerly allowed only grudgingly and subject to arbitrary ceilings, was suddenly welcomed. Approval was made automatic for foreign equity stakes of up to 51 percent in an Indian enterprise, and 100 percent foreign ownership was allowed under certain circumstances. Raw materials and many industrial goods could be freely imported, and the maximum tariff that could be levied on imports was reduced from 400 percent to 65 percent. The top income tax rate was also reduced, and corporate tax fell from 57.5 percent to 46 percent in 1994, and then to 35 percent in 1997. The government also announced plans to start privatizing India's state-owned businesses, some 40 percent of which were losing money in the early 1990s.

Judged by some measures, the response to these economic reforms has been impressive. The economy expanded at an annual rate of about 6.3 percent from 1994 to 2004, and then accelerated to 8 percent annually during 2005–2010. Foreign investment, a key indicator of how attractive foreign companies thought the Indian economy was, jumped from $150 million in 1991 to $36.7 billion in 2008. Some economic sectors have done particularly well, such as the information technology sector where India has emerged as a vibrant global center for software development with sales of $70 billion in 2010 (about 5.1 percent of GDP), up from just $150 million in 1990. In pharmaceuticals too, Indian companies are emerging as credible players in the global marketplace, primarily by selling low-cost, generic versions of drugs that have come off patent in the developed world.

However, the country still has a long way to go. Attempts to further reduce import tariffs have been stalled by political opposition from employers, employees, and politicians, who fear that if barriers come down, a flood of inexpensive Chinese products will enter India. The privatization program continues to hit speed bumps—the latest in September 2003 when the Indian Supreme Court ruled that the government could not privatize two state-owned oil companies without explicit approval from the parliament. State-owned firms still account for 38 percent of national output in the nonfarm sector, yet India's private firms are 30 to 40 percent more productive than their state-owned enterprises. There has also been strong resistance to reforming many of India's laws that make it difficult for private business to operate efficiently. For example, labor laws make it almost impossible for firms with more than 100 employees to fire workers, creating a disincentive for entrepreneurs to grow their enterprises beyond 100 employees. Other laws mandate that certain products can be manufactured only by small companies, effectively making it impossible for companies in these industries to attain the scale required to compete internationally.[38]

shareholders. Sometimes these managers are the same Communist bureaucrats who ran the enterprise before privatization. Because they have been schooled in the old ways of doing things, they often hesitate to take drastic action to increase the efficiency of the enterprise. Instead, they continue to run the firm as a private fiefdom, seeking to extract whatever economic value they can for their own betterment (in the form of perks that are not reported) while doing little to increase the economic efficiency of the enterprise so that shareholders benefit. Such developments seem less likely to occur, however, if a foreign investor takes a stake in the newly privatized entity. The foreign investor, usually a major provider of capital, is often able to use control over a critical resource (money) to push through needed change.

LEGAL SYSTEMS

As noted earlier in this chapter, a well-functioning market economy requires laws protecting private property rights and providing mechanisms for contract enforcement. Without a legal system that protects property rights, and without the machinery to enforce that system, the incentive to engage in economic activity can be reduced substantially by private and public entities, including organized crime, that expropriate the profits generated by the efforts of private-sector entrepreneurs. When communism collapsed, many of these countries lacked the legal structure required to protect property rights, all property having been held by the state. Although many nations have made big strides toward instituting the required system, it will be many more years before the legal system is functioning as smoothly as it does in the West. For example, in most Eastern European nations, the title to urban and agricultural property is often uncertain because of incomplete and inaccurate records, multiple pledges on the same property, and unsettled claims resulting from demands for restitution from owners in the pre-Communist era. Also, although most countries have improved their commercial codes, institutional weaknesses still undermine contract enforcement. Court capacity is often inadequate, and procedures for resolving contract disputes out of court are often lacking or poorly developed.[36] Nevertheless, progress is being made. In 2004, for example, China amended its constitution to state that "private property was not to be encroached upon," and in 2007 it enacted a new law on property rights that gave property holders many of the same protections as those enjoyed by the state (see the Country Focus, "Emerging Property Rights in China").[37]

Implications of Changing Political Economy

The global changes in political and economic systems discussed above have several implications for international business. The long-standing ideological conflict between collectivism and individualism that defined the twentieth century is less in evidence today. The West won the Cold War, and Western ideology is now widespread. Although command economies remain and totalitarian dictatorships can still be found around the world, the tide has been running in favor of free markets and democracy. It remains to be seen, however, whether the global financial crisis of 2008–2009, and the recession that followed, will lead to a retrenchment. Certainly many commentators have blamed the problems that led to this crisis on a lack of regulation, and some reassessment of Western political ideology seems likely.

Notwithstanding the crisis of 2008–2009, the implications for business of the trends of the past two decades are enormous. For nearly 50 years, half of the world was off-limits to Western businesses. Now much of that has changed. Many of the national markets of Eastern Europe, Latin America, Africa, and Asia may still be undeveloped and impoverished, but they are potentially enormous. With a population of more than 1.3 billion, the Chinese market alone is potentially bigger than that of the United States, the European Union, and Japan combined. Similarly India, with its about 1.2 billion people, is a potentially huge market. Latin America has another 400 million potential consumers. It is unlikely that

China, Russia, Vietnam, or any of the other states now moving toward a market system will attain the living standards of the West soon. Nevertheless, the upside potential is so large that companies need to consider making inroads now. For example, if China and the United States continue to grow at the rates they did during 1996–2010, China will surpass the United States to become the world's largest national economy between 2020 and 2025.

Just as the potential gains are large, so are the risks. There is no guarantee that democracy will thrive in many of the world's newer democratic states, particularly if these states have to grapple with severe economic setbacks. Totalitarian dictatorships could return, although they are unlikely to be of the communist variety. Although the bipolar world of the Cold War era has vanished, it may be replaced by a multipolar world dominated by a number of civilizations. In such a world, much of the economic promise inherent in the global shift toward market-based economic systems may stall in the face of conflicts between civilizations. While the long-term potential for economic gain from investment in the world's new market economies is large, the risks associated with any such investment are also substantial. It would be foolish to ignore these. The financial system in China, for example, is not transparent, and many suspect that Chinese banks hold a high proportion of nonperforming loans on their books. If true, these bad debts could trigger a significant financial crisis during the next decade in China, which would dramatically lower growth rates.

IMPLICATIONS FOR MANAGERS

LO4



As noted in the previous chapter, the political, economic, and legal environments of a country clearly influence the attractiveness of that country as a market or investment site. In this chapter we argued that countries with democratic regimes, market-based economic policies, and strong protection of property rights are more likely to attain high and sustained economic growth rates, and are thus a more attractive location for international business. It follows that the benefits, costs, and risks associated with doing business in a country are a function of that country's political, economic, and legal systems. The overall attractiveness of a country as a market or investment site depends on balancing the likely long-term benefits of doing business in that country against the likely costs and risks. Below we consider the determinants of benefits, costs, and risks.

BENEFITS

In the most general sense, the long-run monetary benefits of doing business in a country are a function of the size of the market, the present wealth (purchasing power) of consumers in that market, and the likely future wealth of consumers. While some markets are very large when measured by number of consumers (e.g., China and India), low living standards may imply limited purchasing power and therefore a relatively small market when measured in economic terms. International businesses need to be aware of this distinction, but they also need to keep in mind the likely future prospects of a country. In 1960, South Korea was viewed as just another impoverished Third World nation. By 2010 it was the world's 11th-largest economy, measured in terms of GDP. International firms that recognized South Korea's potential in 1960 and began to do business in that country may have reaped greater benefits than those that wrote off South Korea.

By identifying and investing early in a potential future economic star, international firms may build brand loyalty and gain experience in that country's business practices. These will pay back substantial dividends if that country achieves sustained high economic growth rates. In contrast, late entrants may find that they lack the brand loyalty and experience necessary to achieve a significant presence in the market. In the language of business strategy, early entrants into potential future economic stars may be able to reap substantial first-mover advantages, while late entrants may fall victim to late-mover disadvantages.[39]

(**First-mover advantages** are the advantages that accrue to early entrants into a market. **Late-mover disadvantages** are the handicaps that late entrants might suffer.) This kind of reasoning has been driving significant inward investment into China, which may become the world's second-largest economy between 2020 and 2025 if it continues growing at current rates (China is already the world's fourth-largest national economy). For more than a decade, China has been the largest recipient of foreign direct investment in the developing world as international businesses including General Motors, Volkswagen, Coca-Cola, and Unilever try to establish a sustainable advantage in this nation.

A country's economic system and property rights regime are reasonably good predictors of economic prospects. Countries with free market economies in which property rights are protected tend to achieve greater economic growth rates than command economies or economies where property rights are poorly protected. It follows that a country's economic system, property rights regime, and market size (in terms of population) probably constitute reasonably good indicators of the potential long-run benefits of doing business in a country. In contrast, countries where property rights are not well respected and where corruption is rampant tend to have lower levels of economic growth. One must be careful about generalizing too much from this, however, since both China and India have achieved high growth rates despite relatively weak property rights regimes and high levels of corruption. In both countries, the shift toward a market-based economic system has produced large gains despite weak property rights and endemic corruption.

COSTS

A number of political, economic, and legal factors determine the costs of doing business in a country. With regard to political factors, a company may have to pay off politically powerful entities in a country before the government allows it to do business there. The need to pay what are essentially bribes is greater in closed totalitarian states than in open democratic societies where politicians are held accountable by the electorate (although this is not a hard-and-fast distinction). Whether a company should actually pay bribes in return for market access should be determined on the basis of the legal and ethical implications of such action. We discuss this consideration in Chapter 5, when we look closely at the issue of business ethics.

With regard to economic factors, one of the most important variables is the sophistication of a country's economy. It may be more costly to do business in relatively primitive or undeveloped economies because of the lack of infrastructure and supporting businesses. At the extreme, an international firm may have to provide its own infrastructure and supporting business, which obviously raises costs. When McDonald's decided to open its first restaurant in Moscow, it found that to serve food and drink indistinguishable from that served in McDonald's restaurants elsewhere, it had to vertically integrate backward to supply its own needs. The quality of Russian-grown potatoes and meat was too poor. Thus, to protect the quality of its product, McDonald's set up its own dairy farms, cattle ranches, vegetable plots, and food processing plants within Russia. This raised the cost of doing business in Russia, relative to the cost in more sophisticated economies where high-quality inputs could be purchased on the open market.

As for legal factors, it can be more costly to do business in a country where local laws and regulations set strict standards with regard to product safety, safety in the workplace, environmental pollution, and the like (since adhering to such regulations is costly). It can also be more costly to do business in a country like the United States, where the absence of a cap on damage awards has meant spiraling liability insurance rates. It can be more costly to do business in a country that lacks well-established laws for regulating business practice (as is the case in many of the former Communist nations). In the absence of a well-developed body of business contract law, international firms may find no satisfactory way to resolve contract disputes and, consequently, routinely face large losses from contract violations. Similarly, local laws that fail to adequately protect intellectual property can lead to the theft of an international business's intellectual property and lost income.

RISKS

As with costs, the risks of doing business in a country are determined by a number of political, economic, and legal factors. **Political risk** has been defined as the likelihood that political forces will cause drastic changes in a country's business environment that adversely affect the profit and other goals of a business enterprise.[40] So defined, political risk tends to be greater in countries experiencing social unrest and disorder or in countries where the underlying nature of a society increases the likelihood of social unrest. Social unrest typically finds expression in strikes, demonstrations, terrorism, and violent conflict. Such unrest is more likely to be found in countries that contain more than one ethnic nationality, in countries where competing ideologies are battling for political control, in countries where economic mismanagement has created high inflation and falling living standards, or in countries that straddle the "fault lines" between civilizations.

Social unrest can result in abrupt changes in government and government policy or, in some cases, in protracted civil strife. Such strife tends to have negative economic implications for the profit goals of business enterprises. For example, in the aftermath of the 1979 Islamic revolution in Iran, the Iranian assets of numerous U.S. companies were seized by the new Iranian government without compensation. Similarly, the violent disintegration of the Yugoslavian federation into warring states, including Bosnia, Croatia, and Serbia, precipitated a collapse in the local economies and in the profitability of investments in those countries.

More generally, a change in political regime can result in the enactment of laws that are less favorable to international business. In Venezuela, for example, the populist socialist politician Hugo Chavez won power in 1998, was reelected as president in 2000, and was reelected again in 2006. Chavez has declared himself to be a "Fidelista," a follower of Cuba's Fidel Castro. He has pledged to improve the lot of the poor in Venezuela through government intervention in private business and has frequently railed against American imperialism, all of which is of concern to Western enterprises doing business in the country. Among other actions, he increased the royalties foreign oil companies operating in Venezuela have to pay the government from 1 to 30 percent of sales.

Other risks may arise from a country's mismanagement of its economy. An **economic risk** can be defined as the likelihood that economic mismanagement will cause drastic changes in a country's business environment that hurt the profit and other goals of a particular business enterprise. Economic risks are not independent of political risk. Economic mismanagement may give rise to significant social unrest and hence political risk. Nevertheless, economic risks are worth emphasizing as a separate category because there is not always a one-to-one relationship between economic mismanagement and social unrest. One visible indicator of economic mismanagement tends to be a country's inflation rate. Another is the level of business and government debt in the country.

In Asian states such as Indonesia, Thailand, and South Korea, businesses increased their debt rapidly during the 1990s, often at the behest of the government, which was encouraging them to invest in industries deemed to be of "strategic importance" to the country. The result was overinvestment, with more industrial (factories) and commercial capacity (office space) being built than could be justified by demand conditions. Many of these investments turned out to be uneconomic. The borrowers failed to generate the profits necessary to service their debt payment obligations. In turn, the banks that had lent money to these businesses suddenly found that they had rapid increases in nonperforming loans on their books. Foreign investors, believing that many local companies and banks might go bankrupt, pulled their money out of these countries, selling local stock, bonds, and currency. This action precipitated the 1997–98 financial crises in Southeast Asia. The crisis included a precipitous decline in the value of Asian stock markets, which in some cases exceeded 70 percent; a similar collapse in the value of many Asian currencies against the U.S. dollar; an implosion of local demand; and a severe economic recession that will affect many Asian countries for years. In short, economic risks were rising throughout Southeast Asia during the 1990s. Astute foreign businesses and investors limited their exposure in this part of the world. More naive businesses and investors lost their shirts.

On the legal front, risks arise when a country's legal system fails to provide adequate safeguards in the case of contract violations or to protect property rights. When legal safeguards are weak, firms are more likely to break contracts or steal intellectual property if they perceive it as being in their interests to do so. Thus, a **legal risk** can be defined as the likelihood that a trading partner will opportunistically break a contract or expropriate property rights. When legal risks in a country are high, an international business might hesitate entering into a long-term contract or joint-venture agreement with a firm in that country. For example, in the 1970s when the Indian government passed a law requiring all foreign investors to enter into joint ventures with Indian companies, U.S. companies such as IBM and Coca-Cola closed their investments in India. They believed that the Indian legal system did not provide for adequate protection of intellectual property rights, creating the very real danger that their Indian partners might expropriate the intellectual property of the American companies—which for IBM and Coca-Cola amounted to the core of their competitive advantage.

OVERALL ATTRACTIVENESS

The overall attractiveness of a country as a potential market or investment site for an international business depends on balancing the benefits, costs, and risks associated with doing business in that country (see Figure 3.1). Generally, the costs and risks associated with doing business in a foreign country are typically lower in economically advanced and politically stable democratic nations and greater in less developed and politically unstable nations. The calculus is complicated, however, because the potential long-run benefits are dependent not only upon a nation's current stage of economic development or political stability but also on likely future economic growth rates. Economic growth appears to be a function of a free market system and a country's capacity for growth (which may be greater in less developed nations). This leads one to conclude that, other things being equal, the benefit–cost–risk trade-off is likely to be most favorable in politically stable developed and developing nations that have free market systems and no dramatic upsurge in either inflation rates or private-sector debt. It is likely to be least favorable in politically unstable developing nations that operate with a mixed or command economy or in developing nations where speculative financial bubbles have led to excess borrowing.

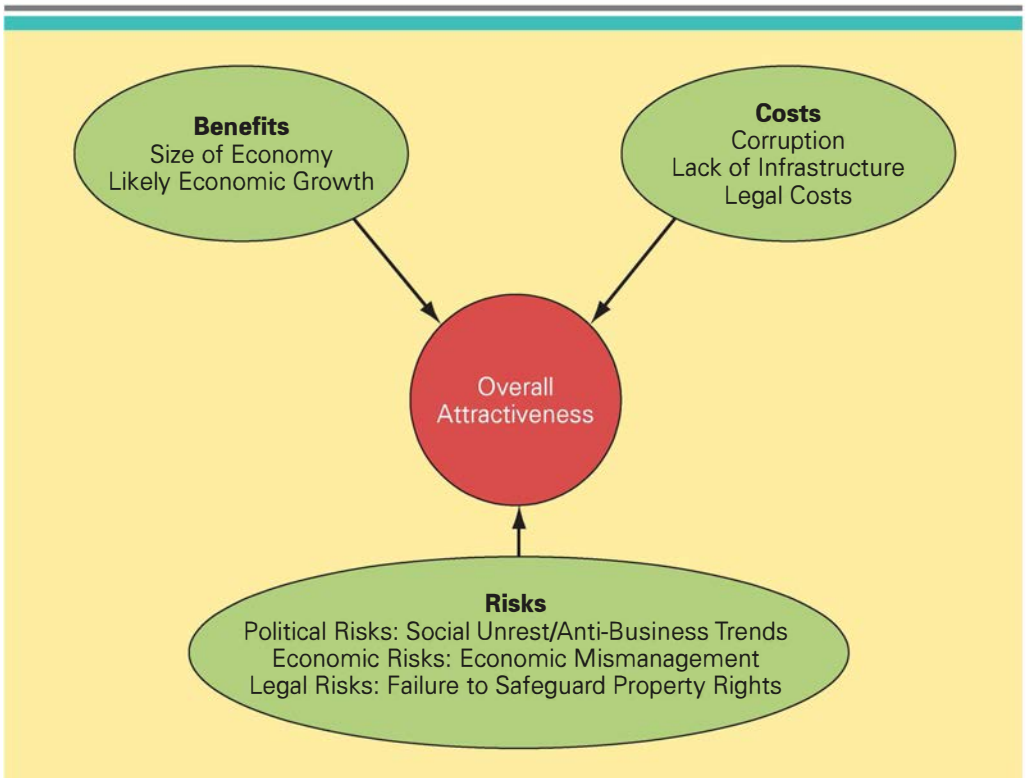


FIGURE 3.1
Country Attractiveness

CHAPTER SUMMARY

This chapter reviewed how the political, economic, and legal systems of countries vary. The potential benefits, costs, and risks of doing business in a country are a function of its political, economic, and legal systems. The chapter made the following points:

1. The rate of economic progress in a country seems to depend on the extent to which that country has a well-functioning market economy in which property rights are protected.
2. Many countries are now in a state of transition. There is a marked shift away from totalitarian governments and command or mixed economic systems and toward democratic political institutions and free market economic systems.
3. The attractiveness of a country as a market and/or investment site depends on balancing the likely long-run benefits of doing business in that country against the likely costs and risks.
4. The benefits of doing business in a country are a function of the size of the market (population), its present wealth (purchasing power), and its future growth prospects. By investing early in countries that are currently poor but are nevertheless growing rapidly, firms can gain first-mover advantages that will pay back substantial dividends in the future.
5. The costs of doing business in a country tend to be greater where political payoffs are required to gain market access, where supporting infrastructure is lacking or underdeveloped, and where adhering to local laws and regulations is costly.
6. The risks of doing business in a country tend to be greater in countries that are politically unstable, subject to economic mismanagement, and lacking a legal system to provide adequate safeguards in the case of contract or property rights violations.

Critical Thinking and Discussion Questions

1. What is the relationship between property rights, corruption, and economic progress? How important are anticorruption efforts in the effort to improve a country's level of economic development?
2. You are a senior manager in a U.S. automobile company considering whether to invest in production facilities in China, Russia, or Germany. These facilities will serve local market demand. Evaluate the benefits, costs, and risks associated with doing business in each nation. Which country seems the most attractive target for foreign direct investment? Why?
3. Reread the Country Focus on India and answer the following questions:
   a. What kind of economic system did India operate under during 1947–1990? What kind of system is it moving toward today? What are the impediments to completing this transformation?
   b. How might widespread public ownership of businesses and extensive government regulations have impacted (*i*) the efficiency of state and private businesses, and (*ii*) the rate of new business formation in India during the 1947–90 time frame? How do you think these factors affected the rate of economic growth in India during this time frame?
   c. How would privatization, deregulation, and the removal of barriers to foreign direct investment affect the efficiency of business, new business formation, and the rate of economic growth in India during the post-1990 time period?
   d. India now has pockets of strengths in key high-technology industries such as software and pharmaceuticals. Why do you think India is developing strength in these areas? How might success in these industries help to generate growth in the other sectors of the Indian economy?
   e. Given what is now occurring in the Indian economy, do you think the country represents an attractive target for inward investment by foreign multinationals selling consumer products? Why?

Research Task globalEDGE globaledge.msu.edu

Political Economy and Economic Development

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

Increased instability in the global marketplace can introduce risks in a company's daily transactions which can be unanticipated. As such, your company must evaluate these *commercial transaction* risks for its foreign operations in Argentina, China, the Czech Republic, India, Indonesia, and the United Arab Emirates. A risk analyst at your firm indicated that you could evaluate both the political and commercial risk of these countries simultaneously. Provide a commercial transaction risk overview of all six countries for top management. In your evaluation, indicate possible corrective measures in the countries with considerably high political and/or commercial risk.

Exercise 2

Managers at your firm are very concerned about the influence of *terrorism* on its long-term strategy. To counter this issue, the CEO has indicated you must analyze the countries in which terrorism and political violence is minimal. As this will provide the basis for the development of future company facilities, a detailed analysis for these countries is required. Once completed, include recommendations which justify locating future operations to specific countries with little risk of terror activities.

CLOSING CASE

Japan's Economic Malaise

In 1989 Japan was widely viewed as an economic superpower. After three decades of robust economic growth it had risen to become the world's second-largest economy. Japanese companies seemed to be obliterating entire American industries, from automobiles and semiconductors to earthmoving equipment and consumer electronics. Japanese companies were buying assets in the United States, including movie studios (Universal Studios and Columbia Pictures), golf courses (Pebble Beach), and real estate (the Rockefeller Center in New York). The stock market was booming, the Nikkei index hitting an all-time high of 38,957 in December 1989, an increase of more than 600 percent since 1980. Property prices had risen so much that one square mile of Tokyo was said to be worth more than the entire United States. Books were written about the Japanese threat to American dominance. Management theorists praised Japanese companies for their strategic savvy and management excellence. Economists were predicting that Japan would overtake America to become the world's largest economy by 2010.

It didn't happen. In quick succession the stock market collapsed and property prices rapidly followed it down. Japanese banks, which had financed much of the boom in asset prices with easy money, now found their balance sheets loaded with bad debt, and they sharply contracted lending. As the stock market plunged and property prices imploded, individuals saw their net worth shrink. Japanese consumers responded by sharply reducing spending, depressing domestic demand and sending the economy into a recession. And there it stayed—for most of the next two decades. Today the Japanese economy is barely larger in real terms than it was in 1989. In 2010, China passed Japan to become the world's second-largest economy. The average price of a home in Japan is the same as it was in 1983, way below the 1989 peak. The Nikkei stock market index stood at 9,600 in early 2011, 75 percent below its 1989 high. And worst of all, Japan has been gripped by deflation for the best part of two decades.

Deflation is a situation where prices are falling. When consumers and businesses expect prices to be lower tomorrow than they are today, they react by putting off spending, by hoarding cash, since that cash will buy more tomorrow than it will today. Such behavior can result in a negative cycle. Expectations that prices will fall can lead to reduced demand. Businesses respond by cutting prices further to try to get consumers to spend. Seeing this, consumers react by waiting to buy in expectation that prices will again fall in the future, and so demand continues to decline, which results in additional price cuts to try to stimulate demand, and so on. As businesses see their revenues and margins fall, they reduce employment and cut wages and salaries. This further

reduces spending power and adds to the deflationary cycle. To make matters worse, in a deflationary environment the real cost of debt goes up over time. While prices and wages fall, people still have to make fixed payments on their mortgages and car loans. Over time, this takes up an ever-greater proportion of their income, further limiting their ability to spend more on other goods and services.

All of this has happened in Japan over the past 20 years. For its part, after initially being slow to respond to falling asset prices, during the past 15 years the Japanese government has repeatedly tried to stimulate the economy and reignite consumer spending. Interest rates have been cut to zero and major investments have been made in public infrastructure. Not only has this not worked, but it has also left Japan with the highest level of government debt as a percentage of GDP in the world, amounting to some 200 percent of GDP (in contrast, the figure for the United States in 2011 was about 97 percent of GDP). The high debt load is now a limit on the ability of the Japanese government to adopt additional expansionary policies.

In seeking to explain Japan's prolonged malaise, many economists also point to demographic factors. In the 1970s and 1980s birthrates in Japan fell below replacement levels, leaving it with one of the oldest populations in the world. The working age population peaked at 87 million in 1995 and has been falling since. On current trends, by 2030 it will be 67 million. Every year there are fewer and fewer working age people to support ever more retired people—and Japan's retired people are notorious for not spending. Japan could reverse this trend by increasing immigration or boosting the birthrate, but neither of these seems likely at the moment. Increasingly, young people are pessimistic about the future. All they have known is a world where prices for everything, including the price of labor, have fallen. They have diminished expectations.[41]

Case Discussion Questions

1. In the 1980s Japan was viewed as one of the world's most dynamic economies. Today it is viewed as one of its most stagnant. Why has the Japanese economy stagnated?
2. What lessons does the history of Japan over the past 20 years hold for other nations? What can countries do to avoid the kind of deflationary spiral that has gripped Japan?
3. What do you think would be required to get the Japanese economy moving again?
4. What are the implications of Japan's economic stagnation for the benefits, costs, and risks of doing business in this nation?
5. As an international business, which economy would you rather invest in, that of Japan or that of India? Explain your answer.

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4 Differences in Culture

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Explain what is meant by the culture of a society.
- **LO2** Identify the forces that lead to differences in social culture.
- **LO3** Identify the business and economic implications of differences in culture.
- **LO4** Recognize how differences in social culture influence values in the workplace.
- **LO5** Demonstrate an appreciation for the economic and business implications of cultural change.

Culture and Business in Saudi Arabia

Saudi Arabia is not the easiest place in the world for Western enterprises to do business. On the one hand, the oil-rich kingdom offers many opportunities for enterprising businesses. Western construction companies have long played a role in building infrastructure in the kingdom. Western brands from Coca-Cola, Nike, and McDonald's to Body Shop, Next, and Benetton have a significant presence. Western aerospace companies such as Boeing and Lockheed have sold a significant number of aircraft to Saudi Arabia over the years. The Saudi market is one of the larger in the Middle East. For more than a decade now, the government has signaled that it is more open to foreign investment in certain sectors of the economy, although oil and gas extraction is still reserved for state-owned enterprises.

On the other hand, Saudi Arabia is a historically conservative country where a large segment of the population desires to preserve the religious values and ancient traditions of the region. This can and does spill over into the business sector. The culture of the country has been shaped by a combination of Islam and Bedouin traditions. In 1744 when desert nomads populated the Arabian Peninsula, the oasis-dwelling al Saud clan made a pact with Ibn Abd-al-Wahhab. Wahhab was an influential Islamic scholar who sought to purify Islam and return it to its traditional roots through strict adherence to what he believed were the original principles of Islam, as expressed in the Koran. In exchange for protecting Wahhab and following his teachings, Wahhab offered his backing to the ambitious al Saud family. One hundred and forty years later, the family united the nomadic desert tribes under their rule, and in 1922 the Saudi Kingdom was born.

Today, the strict Wahhab sect of Islam still has a profound influence on Saudi culture, something that is very visible to foreign travelers. For example, stores and restaurants close at the five daily prayer times, and many restaurants, including Western ones such as McDonald's, have separate dining areas for men and women. Women in Saudi Arabia are not allowed to drive a car, sail a boat, or fly a plane, or to appear outdoors with hair, wrists, or ankles exposed—something that Western companies need to keep in mind when doing business in the country or with Saudis elsewhere. Indeed, women traveling on their own have generally needed government minders or permission slips.

Saudi adherence to Islamic values has also given rise to anti-American sentiment, which increased following the American-led invasion of another Muslim nation, Iraq. Cultural solidarity expressed itself in consumer boycotts of American products. More disturbing than consumer boycotts have been terrorist attacks against Western expatriates



in Saudi Arabia during the past decade, significantly increasing the perceived risks of doing business in the kingdom.

Bedouin traditions have been just as strong as Islamic values in shaping Saudi culture. Values that were important to those proud nomads, and enabled them to survive in their harsh desert landscape, are still found in modern Saudi society. They include loyalty, status, an emphasis on interpersonal relationships, the idea of approximate rather than precise time, and an aversion to any behavior that might seem menial or servile (including manual labor).

Reflecting Bedouin traditions, Saudis will often conduct business only after trust has been well established—a process that might require (by Western standards) a large number of face-to-face meetings. Saudis may resent being rushed into a business decision, preferring to let discussions proceed in a more relaxed fashion—something that Westerners with their attachment to precise rather than approximate time might find taxing. Business meetings may be long because many Saudis maintain an "open office" and will interrupt a meeting to conduct other business, which can be traced back to the Bedouin tradition where all tribal members have a right to visit and petition their leaders without an appointment. Given the cultural importance attached to status, Saudi executives will not react well if a foreign company sends a junior executive to transact business.

Loyalty to family and friends is a powerful force, and job security and advancement may be based on family and friendship ties, rather than, or in addition to, demonstrated technical or managerial competence. Westerners might construe this negatively as nepotism, but it reflects a nomadic culture where trust in family and tribe was placed above all else. Saudi executives will also consult with family and friends before making a business decision, and they may place more weight on their opinions than that of experts whom they do not know as well.

The Bedouin aversion to menial work has produced a chronic labor problem in the kingdom, and foreign companies will quickly discover that it is difficult to find Saudi nationals who will undertake manual labor or basic service work. Consequently, some 6 million foreign nationals reside in Saudi Arabia. These expatriates, who are primarily from other Muslim nations, such as Pakistan and Indonesia, undertake many of the menial occupations that Saudis disdain. Although oil revenues have made this social stratification possible, the Saudi government sees it as a potential long-term problem—almost 90 percent of all private-sector jobs in Saudi Arabia are filled by foreign nationals—and it

has launched a program of "Saudiazation." The aim is to change cultural values toward work perceived as menial, and by doing so, to help build a modern economy. So far success had been halting at best.

Saudi society is starting to change in other important ways. Slowly the rights of Saudi women are being expanded. In 1964, Saudi girls were not allowed to go to school; today more than half of university students in the kingdom are women. In 2004, Saudi women were granted the right to hold commercial business licenses, a significant advance considering the women held some $25 billion in deposits in Saudi banks and had little opportunity to use them. As Saudi society evolves, women may come to play a greater role in business.[1]

Introduction

In Chapters 2 and 3, we saw how national differences in political, economic, and legal systems influence the benefits, costs, and risks associated with doing business in different countries. In this chapter, we will explore how differences in culture across and within countries can affect international business. Several themes run through this chapter. The first is that business success in a variety of countries requires cross-cultural literacy. By **cross-cultural literacy**, we mean an understanding of how cultural differences across and within nations can affect the way business is practiced. In these days of global communications, rapid transportation, worldwide markets, and global brands, when the era of the global village seems just around the corner, it is easy to forget just how different various cultures really are. Underneath the veneer of modernism, deep cultural differences often remain.[2]

For example, increasingly, many Saudis are embracing the material products of modern society. Saudi cities in particular seem modern with their office blocks, department stores, malls, and freeways. But as the opening case demonstrates, beneath the veneer of Western modernism, long-standing cultural values that date back to Bedouin traditions and the strict Wahhab interpretation of Islam have a profound influence on this society. Foreign managers in Saudi Arabia need to be aware of these traditions and how they might affect the business process in the kingdom. Generalizing from this example, in this chapter, we shall argue that it is important for foreign businesses to gain an understanding of the culture that prevails in those countries where they do business, and that success requires a foreign enterprise to adapt to the culture of its host country.[3]

Another theme developed in this chapter is that a relationship may exist between culture and the cost of doing business in a country or region. Different cultures are more or less supportive of the capitalist mode of production and may increase or lower the costs of doing business. For example, some observers have argued that cultural factors lowered the costs of doing business in Japan and helped to explain Japan's rapid economic ascent during the 1960s, 70s, and 80s.[4] Similarly, cultural factors can sometimes raise the costs of doing business. Historically, class divisions were an important aspect of British culture, and for a long time, firms operating in Great Britain found it difficult to achieve cooperation between management and labor. Class divisions led to a high level of industrial disputes in that country during the 1960s and 1970s and raised the costs of doing business relative to the costs in countries such as Switzerland, Norway, Germany, or Japan, where class conflict was historically less prevalent.

The British example, however, brings us to another theme we will explore in this chapter. Culture is not static. It can and does evolve, although the rate at which culture can change is the subject of some dispute. Important aspects of British culture have changed significantly over the past 30 years, and this is reflected in weaker class distinctions and a lower level of industrial disputes. Between 1995 and 2005, the number of days lost per 1,000 workers due to strikes in the United Kingdom was on average 28 each year, significantly less than in the United States (33 each year), Ireland (81), and Canada (168).[5] Finally, it is important to note that multinational enterprises can themselves be engines of cultural change. In India, for example, McDonald's and other Western fast-food companies may help to change the dining culture of that nation, drawing them away from traditional restaurants and toward fast-food outlets.

What Is Culture? LO1

Scholars have never been able to agree on a simple definition of *culture*. In the 1870s, the anthropologist Edward Tylor defined culture as "that complex whole which includes knowledge, belief, art, morals, law, custom, and other capabilities acquired by man as a member of society."[6] Since then hundreds of other definitions have been offered. Geert Hofstede, an expert on cross-cultural differences and management, defined culture as "the collective programming of the mind which distinguishes the members of one human group from another. . . . Culture, in this sense, includes systems of values; and values are among the building blocks of culture."[7] Another definition of culture comes from sociologists Zvi Namenwirth and Robert Weber, who see culture as a system of ideas and argue that these ideas constitute a design for living.[8]

Here we follow both Hofstede and Namenwirth and Weber by viewing **culture** as a system of values and norms that are shared among a group of people and that when taken together constitute a design for living. By **values** we mean abstract ideas about what a group believes to be good, right, and desirable. Put differently, values are shared assumptions about how things ought to be.[9] By **norms** we mean the social rules and guidelines that prescribe appropriate behavior in particular situations. We shall use the term **society** to refer to a group of people who share a common set of values and norms. While a society may be equivalent to a country, some countries harbor several societies (i.e., they support multiple cultures), and some societies embrace more than one country.

VALUES AND NORMS

Values form the bedrock of a culture. They provide the context within which a society's norms are established and justified. They may include a society's attitudes toward such concepts as individual freedom, democracy, truth, justice, honesty, loyalty, social obligations, collective responsibility, the role of women, love, sex, marriage, and so on. Values are not just abstract concepts; they are invested with considerable emotional significance. People argue, fight, and even die over values such as freedom. Values also often are reflected in the political and economic systems of a society. As we saw in Chapter 2, democratic free market capitalism is a reflection of a philosophical value system that emphasizes individual freedom.

Norms are the social rules that govern people's actions toward one another. Norms can be subdivided further into two major categories: folkways and mores. **Folkways** are the routine conventions of everyday life. Generally, folkways are actions of little moral significance. Rather, they are social conventions concerning things such as the appropriate dress code in a particular situation, good social manners, eating with the correct utensils, neighborly behavior, and the like. Although folkways define the way people are expected to behave, violation of them is not normally a serious matter. People who violate folkways may be thought of as eccentric or ill-mannered, but they are not usually considered to be evil or bad. In many countries, foreigners may initially be excused for violating folkways.

A good example of folkways concerns attitudes toward time in different countries. People are keenly aware of the passage of time in the United States and Northern European cultures such as Germany and Britain. Businesspeople are very conscious about scheduling their time and are quickly irritated when their time is wasted because a business associate is late for a meeting or if they are kept waiting. They talk about time as though it were money, as something that can be spent, saved, wasted, and lost.[10] Alternatively, in many Arabic, Latin, and African cultures time has a more elastic character. Keeping to a schedule is viewed as less important than finishing an interaction with people. For example, an American businesswoman might feel slighted if she is kept waiting for 30 minutes outside the office of a Latin American executive before a meeting, but the Latin American may simply be completing an interaction with an associate and view the information gathered from this as more important than sticking to a rigid schedule. The Latin American executive intends no disrespect, but due to a mutual misunderstanding about the importance of time, the American may see things differently. Similarly, as noted in the opening case, Saudi attitudes



Understanding rituals and symbolic behaviors is essential to doing business in foreign countries.

to time have been shaped by their nomadic Bedouin heritage, in which precise time played no real role and arriving somewhere tomorrow might mean next week. Like Latin Americans, many Saudis are unlikely to understand the American obsession with precise time and schedules, and Americans need to adjust their expectations accordingly.

Folkways include rituals and symbolic behavior. Rituals and symbols are the most visible manifestations of a culture and constitute the outward expression of deeper values. For example, upon meeting a foreign business executive, a Japanese executive will hold his business card in both hands and bow while presenting the card to the foreigner.[11] This ritual behavior is loaded with deep cultural symbolism. The card specifies the rank of the Japanese executive, which is a very important piece of information in a hierarchical society such as Japan (Japanese often have business cards with Japanese printed on one side and English printed on the other). The bow is a sign of respect, and the deeper the angle of the bow, the greater the reverence one person shows for the other. The person receiving the card is expected to examine it carefully, which is a way of returning respect and acknowledging the card giver's position in the hierarchy. The foreigner is also expected to bow when taking the card, and to return the greeting by presenting the Japanese executive with his own card, similarly bowing in the process. To not do so, and to fail to read the card that he has been given, instead casually placing it in his jacket, violates this important folkway and is considered rude.

Mores are norms that are seen as central to the functioning of a society and to its social life. They have much greater significance than folkways. Accordingly, violating mores can bring serious retribution. Mores include such factors as indictments against theft, adultery, incest, and cannibalism. In many societies, certain mores have been enacted into law. Thus, all advanced societies have laws against theft, incest, and cannibalism. However, there are also many differences between cultures. In America, for example, drinking alcohol is widely accepted, whereas in Saudi Arabia the consumption of alcohol is viewed as violating important social mores and is punishable by imprisonment (as some Western citizens working in Saudi Arabia have discovered).

CULTURE, SOCIETY, AND THE NATION-STATE

We have defined a society as a group of people that share a common set of values and norms, that is, people who are bound together by a common culture. There is not a strict one-to-one correspondence between a society and a nation-state. Nation-states are political creations. They may contain a single culture or several cultures. While the French nation can be thought of as the political embodiment of French culture, the nation of Canada has at least three cultures—an Anglo culture, a French-speaking "Quebecois" culture, and a Native American culture. Similarly, many African nations have important cultural differences between tribal groups, as exhibited in the early 1990s when Rwanda dissolved into a bloody civil war between two tribes, the Tutsis and Hutus. Africa is not alone in this regard. India is composed of many distinct cultural groups. During the first Gulf War in 1991, the prevailing view presented to Western audiences was that Iraq was a homogenous Arab nation. However, since then we have learned that several different societies exist within Iraq, each with its own culture. The Kurds in the north do not view themselves as Arabs and have their own distinct history and traditions. There are two Arab societies: the Shiites in the South and the Sunnis who populate the middle of the country and who ruled Iraq under the regime of Saddam Hussein (the terms *Shiites* and *Sunnis* refer to different sects within the religion of Islam). Among the southern Sunnis is another distinct society of 500,000 Marsh Arabs who live at the confluence of the Tigris and Euphrates Rivers, pursuing a way of life that dates back 5,000 years.[12]

At the other end of the scale are cultures that embrace several nations. Several scholars argue that we can speak of an Islamic society or culture that is shared by the citizens of many different nations in the Middle East, Asia, and Africa. As you will recall from the previous chapter, this view of expansive cultures that embrace several nations underpins Samuel Huntington's view of a world that is fragmented into different civilizations, including Western, Islamic, and Sinic (Chinese).[13]

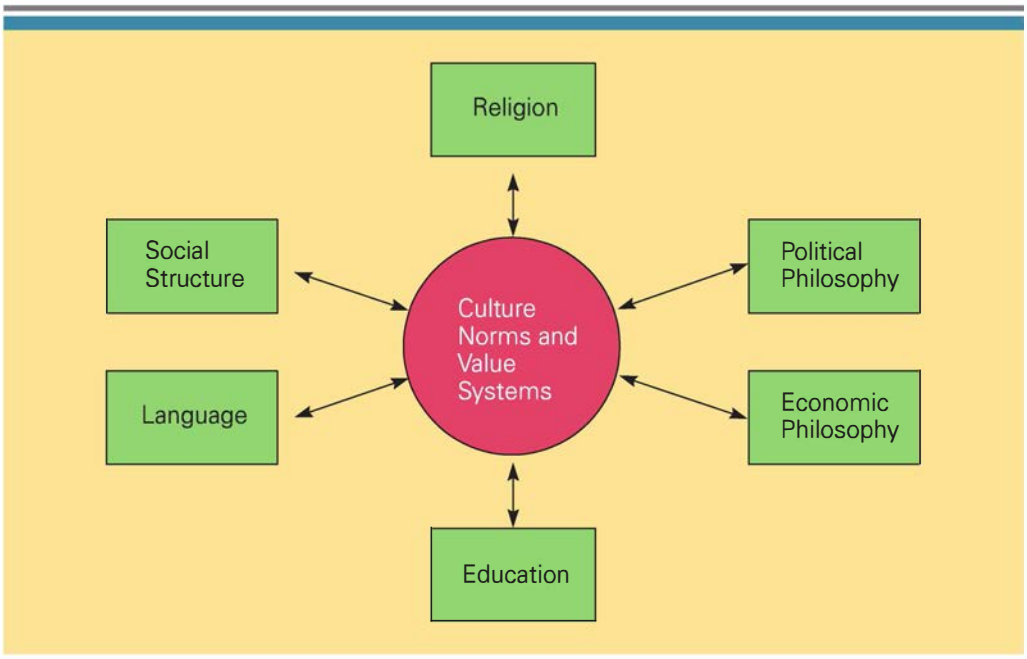


FIGURE 4.1
The Determinants of Culture

To complicate things further, it is also possible to talk about culture at different levels. It is reasonable to talk about "American society" and "American culture," but there are several societies within America, each with its own culture. One can talk about African-American culture, Cajun culture, Chinese-American culture, Hispanic culture, Indian culture, Irish-American culture, and Southern culture. The relationship between culture and country is often ambiguous. Even if a country can be characterized as having a single homogenous culture, often that national culture is a mosaic of subcultures.

THE DETERMINANTS OF CULTURE

LO²

The values and norms of a culture do not emerge fully formed. They evolve over time in response to a number of factors, including prevailing political and economic philosophies, the social structure of a society, and the dominant religion, language, and education (see Figure 4.1). We discussed political and economic philosophies in Chapter 2. Such philosophies clearly influence the value systems of a society. For example, the values found in Communist North Korea toward freedom, justice, and individual achievement are clearly different from the values found in the United States, precisely because each society operates according to different political and economic philosophies. Below we will discuss the influence of social structure, religion, language, and education. The chain of causation runs both ways. While factors such as social structure and religion clearly influence the values and norms of a society, the values and norms of a society can influence social structure and religion.

Social Structure

A society's **social structure** refers to its basic social organization. Although social structure consists of many different aspects, two dimensions are particularly important when explaining differences between cultures. The first is the degree to which the basic unit of social organization is the individual, as opposed to the group. In general, Western societies tend to emphasize the primacy of the individual, whereas groups tend to figure much larger in many other societies. The second dimension is the degree to which a society is stratified into classes or castes. Some societies are characterized by a relatively high degree of social stratification and relatively low mobility between strata (e.g., Indian); other societies are characterized by a low degree of social stratification and high mobility between strata (e.g., American).

INDIVIDUALS AND GROUPS

A **group** is an association of two or more individuals who have a shared sense of identity and who interact with each other in structured ways on the basis of a common set of expectations about each other's behavior.[14] Human social life is group life. Individuals are involved in families, work groups, social groups, recreational groups, and so on. However, while groups are found in all societies, societies differ according to the degree to which the group is viewed as the primary means of social organization.[15] In some societies, individual attributes and achievements are viewed as being more important than group membership; in others the reverse is true.

The Individual

In Chapter 2, we discussed individualism as a political philosophy. However, individualism is more than just an abstract political philosophy. In many Western societies, the individual is the basic building block of social organization. This is reflected not just in the political and economic organization of society but also in the way people perceive themselves and relate to each other in social and business settings. The value systems of many Western societies, for example, emphasize individual achievement. The social standing of individuals is not so much a function of whom they work for as of their individual performance in whatever work setting they choose.

LO3 The emphasis on individual performance in many Western societies has both beneficial and harmful aspects. In the United States, the emphasis on individual performance finds expression in an admiration of rugged individualism and entrepreneurship. One benefit of this is the high level of entrepreneurial activity in the United States and other Western societies. Entrepreneurial individuals in the United States have created many new products and new ways of doing business (e.g., personal computers, photocopiers, computer software, biotechnology, supermarkets, and discount retail stores). One can argue that the dynamism of the U.S. economy owes much to the philosophy of individualism.

Individualism also finds expression in a high degree of managerial mobility between companies, and this is not always a good thing. Although moving from company to company may be good for individual managers who are trying to build impressive résumés, it is not necessarily a good thing for American companies. The lack of loyalty and commitment to an individual company, and the tendency to move on for a better offer, can result in managers who have good general skills but lack the knowledge, experience, and network of interpersonal contacts that come from years of working within the same company. An effective manager draws on company-specific experience, knowledge, and a network of contacts to find solutions to current problems, and American companies may suffer if their managers lack these attributes. One positive aspect of high managerial mobility is that executives are exposed to different ways of doing business. The ability to compare business practices helps U.S. executives identify how good practices and techniques developed in one firm might be profitably applied to other firms.

The emphasis on individualism may also make it difficult to build teams within an organization to perform collective tasks. If individuals are always competing with each other on the basis of individual performance, it may be difficult for them to cooperate. A study of U.S. competitiveness by the Massachusetts Institute of Technology suggested that U.S. firms are being hurt in the global economy by a failure to achieve cooperation both within a company (e.g., between functions; between management and labor) and between companies (e.g., between a firm and its suppliers). Given the emphasis on individualism in the American value system, this failure is not surprising.[16] The emphasis on individualism in the United States, while helping to create a dynamic entrepreneurial economy, may raise the costs of doing business due to its adverse impact on managerial stability and cooperation.

The Group

In contrast to the Western emphasis on the individual, the group is the primary unit of social organization in many other societies. For example, in Japan, the social status of an

individual is determined as much by the standing of the group to which he or she belongs as by his or her individual performance.[17] In traditional Japanese society, the group was the family or village to which an individual belonged. Today, the group has frequently come to be associated with the work team or business organization to which an individual belongs. In a now-classic study of Japanese society, Nakane noted how this expresses itself in everyday life:

> When a Japanese faces the outside (confronts another person) and affixes some position to himself socially he is inclined to give precedence to institution over kind of occupation. Rather than saying, "I am a typesetter" or "I am a filing clerk," he is likely to say, "I am from B Publishing Group" or "I belong to S company."[18]

LO3

Nakane goes on to observe that the primacy of the group to which an individual belongs often evolves into a deeply emotional attachment in which identification with the group becomes all-important in one's life. One central value of Japanese culture is the importance attached to group membership. This may have beneficial implications for business firms. Strong identification with the group is argued to create pressures for mutual self-help and collective action. If the worth of an individual is closely linked to the achievements of the group (e.g., firm), as Nakane maintains is the case in Japan, this creates a strong incentive for individual members of the group to work together for the common good. Some argue that the success of Japanese enterprises in the global economy has been based partly on their ability to achieve close cooperation between individuals within a company and between companies. This has found expression in the widespread diffusion of self-managing work teams within Japanese organizations, the close cooperation among different functions within Japanese companies (e.g., among manufacturing, marketing, and R&D), and the cooperation between a company and its suppliers on issues such as design, quality control, and inventory reduction.[19] In all of these cases, cooperation is driven by the need to improve the performance of the group (i.e., the business firm).

The primacy of the value of group identification also discourages managers and workers from moving from company to company. Lifetime employment in a particular company was long the norm in certain sectors of the Japanese economy (estimates suggest that between 20 and 40 percent of all Japanese employees have formal or informal lifetime employment guarantees). Over the years, managers and workers build up knowledge, experience, and a network of interpersonal business contacts. All these things can help managers perform their jobs more effectively and achieve cooperation with others.

However, the primacy of the group is not always beneficial. Just as U.S. society is characterized by a great deal of dynamism and entrepreneurship, reflecting the primacy of values associated with individualism, some argue that Japanese society is characterized by a corresponding lack of dynamism and entrepreneurship. Although the long-run consequences are unclear, the United States could continue to create more new industries than Japan and continue to be more successful at pioneering radically new products and new ways of doing business.

SOCIAL STRATIFICATION

LO2

All societies are stratified on a hierarchical basis into social categories—that is, into **social strata**. These strata are typically defined on the basis of characteristics such as family background, occupation, and income. Individuals are born into a particular stratum. They become a member of the social category to which their parents belong. Individuals born into a stratum toward the top of the social hierarchy tend to have better life chances than those born into a stratum toward the bottom of the hierarchy. They are likely to have better education, health, standard of living, and work opportunities. Although all societies are stratified to some degree, they differ in two related ways. First, they differ from each other with regard to the degree of mobility between social strata; second, they differ with regard to the significance attached to social strata in business contexts.

Social Mobility

The term **social mobility** refers to the extent to which individuals can move out of the strata into which they are born. Social mobility varies significantly from society to society. The most rigid system of stratification is a caste system. A **caste system** is a closed system of stratification in which social position is determined by the family into which a person is born, and change in that position is usually not possible during an individual's lifetime. Often a caste position carries with it a specific occupation. Members of one caste might be shoemakers, members of another might be butchers, and so on. These occupations are embedded in the caste and passed down through the family to succeeding generations. Although the number of societies with caste systems diminished rapidly during the twentieth century, one partial example still remains. India has four main castes and several thousand subcastes. Even though the caste system was officially abolished in 1949, two years after India became independent, it is still a force in rural Indian society where occupation and marital opportunities are still partly related to caste (for more details, see the accompanying Country Focus on the caste system in India today).[20]

A **class system** is a less rigid form of social stratification in which social mobility is possible. It is a form of open stratification in which the position a person has by birth can be changed through his or her own achievements or luck. Individuals born into a class at the bottom of the hierarchy can work their way up; conversely, individuals born into a class at the top of the hierarchy can slip down.

While many societies have class systems, social mobility within a class system varies from society to society. For example, some sociologists have argued that Britain has a more rigid class structure than certain other Western societies, such as the United States.[22] Historically, British society was divided into three main classes: the upper class, which was made up of individuals whose families for generations had wealth, prestige, and occasionally power; the middle class, whose members were involved in professional, managerial, and clerical occupations; and the working class, whose members earned their living from manual occupations. The middle class was further subdivided into the upper-middle class, whose members were involved in important managerial occupations and the prestigious professions (e.g., lawyers, accountants, doctors), and the lower-middle class, whose members were involved in clerical work (e.g., bank tellers) and the less prestigious professions (e.g., schoolteachers).

The British class system exhibited significant divergence between the life chances of members of different classes. The upper and upper-middle classes typically sent their children to a select group of private schools, where they wouldn't mix with lower-class children, and where they picked up many of the speech accents and social norms that marked them as being from the higher strata of society. These same private schools also had close ties with the most prestigious universities, such as Oxford and Cambridge. Until fairly recently, Oxford and Cambridge guaranteed a certain number of places for the graduates of these private schools. Having been to a prestigious university, the offspring of the upper and upper-middle classes then had an excellent chance of being offered a prestigious job in companies, banks, brokerage firms, and law firms run by members of the upper and upper-middle classes.

In contrast, the members of the British working and lower-middle classes typically went to state schools. The majority left at 16, and those who went on to higher education found it more difficult to get accepted at the best universities. When they did, they found that their lower-class accent and lack of social skills marked them as being from a lower social stratum, which made it more difficult for them to get access to the most prestigious jobs.

Because of this, the class system in Britain perpetuated itself from generation to generation, and mobility was limited. Although upward mobility was possible, it could not normally be achieved in one generation. While an individual from a working-class background may have established an income level that was consistent with membership in the upper-middle class, he or she may not have been accepted as such by others of that



COUNTRY FOCUS

Breaking India's Caste System

Modern India is a country of dramatic contrasts. Its information technology sector is among the most vibrant in the world with companies such as Infosys and Wipro emerging as powerful global players. India's caste system, long an impediment to social mobility, is a fading memory among the educated, urban middle-class Indians who make up the majority of employees in the high-tech economy. However, the same is not true in rural India, where 70 percent of the nation's population still resides. There caste remains a pervasive influence. In 1950, the national constitution reserved 22.5 percent of jobs for people from the lower castes, or *dalits* (also known as "untouchables") and for tribal people. In 1990, an additional 27 percent of jobs were set aside for what were called "other backward castes." Some Indian states set higher quotas, including Tamil Nadu, which reserves 69 percent of government jobs for lower castes and other needy groups. Despite these long-standing policies, anecdotal and hard evidence suggests caste still plays an important role in daily life.

For example, a young female engineer at Infosys who grew up in a small rural village and is a *dalit* recounts how she never entered the house of a *Brahmin*, India's elite priestly cast, even though half of her village was *Brahmins*. When a *dalit* was hired to cook at the school in her native village, *Brahmins* withdrew their children from the school. The engineer herself is the beneficiary of a charitable training scheme that Infosys launched in 2006. Her caste is among the poorest in India, with some 91 percent making less than $100 a month, compared to 65 percent of *Brahmins*.

To try to correct this historic inequality, politicians have talked for years about extending the employment quota system to private enterprises. The government has told private companies to hire more *dalits* and members of tribal communities, and warned that "strong measures" will be taken if companies do not comply. Private employers are resisting attempts to impose quotas, arguing with some justification that people who are guaranteed a job by a quota system are unlikely to work very hard. At the same time, progressive employers realize they need to do something to correct the inequalities, and unless India taps into the lower castes, it may not be able to find the employees required to staff rapidly growing high-technology enterprises. Thus, the Confederation of Indian Industry recently introduced a package of *dalit*-friendly measures, including scholarships for bright lower-caste children. Building on this, Infosys is leading the way among high-tech enterprises. The company provides special training to low-caste engineering graduates who have failed to get a job in industry after graduation. While the training does not promise employment, so far almost all graduates who completed the seven-month training program have been hired by Infosys and other enterprises.[21]

class due to accent and background. However, by sending his or her offspring to the "right kind of school," the individual could ensure that his or her children were accepted.

According to many commentators, modern British society is now rapidly leaving this class structure behind and moving toward a classless society. However, sociologists continue to dispute this finding and present evidence that this is not the case. For example, one study reported that state schools in the London suburb of Islington, which has a population of 175,000, had only 79 candidates for university, while one prestigious private school alone, Eton, sent more than that number to Oxford and Cambridge.[23] This, according to the study's authors, implies that "money still begets money." They argue that a good school means a good university, a good university means a good job, and merit has only a limited chance of elbowing its way into this tight little circle. In another recent survey of the empirical literature, a sociologist noted that class differentials in educational achievement have changed surprisingly little over the last few decades in many societies, despite assumptions to the contrary.[24]

The class system in the United States is less pronounced than in Britain and mobility is greater. Like Britain, the United States has its own upper, middle, and working classes. However, class membership is determined to a much greater degree by individual economic achievements, as opposed to background and schooling. Thus, an individual can,



Until the 1970s, social mobility in China was very limited, but now sociologists believe a new class system is emerging in China based less on the rural–urban divide and more on urban occupation.

by his or her own economic achievement, move smoothly from the working class to the upper class in a lifetime. Successful individuals from humble origins are highly respected in American society.

Another society where class divisions have historically been of some importance has been China, where there has been a long-standing difference between the life chances of the rural peasantry and urban dwellers. Ironically, this historic division was strengthened during the high point of Communist rule because of a rigid system of household registration that restricted most Chinese to the place of their birth for their lifetime. Bound to collective farming, peasants were cut off from many urban privileges—compulsory education, quality schools, health care, public housing, varieties of foodstuffs, to name only a few—and they largely lived in poverty. Social mobility was thus very limited. This system crumbled following reforms of the late 1970s and early 1980s, and as a consequence, migrant peasant laborers have flooded into China's cities looking for work. Sociologists now hypothesize that a new class system is emerging in China based less on the rural–urban divide and more on urban occupation.[25]

LO3 Significance

From a business perspective, the stratification of a society is significant if it affects the operation of business organizations. In American society, the high degree of social mobility and the extreme emphasis on individualism limit the impact of class background on business operations. The same is true in Japan, where most of the population perceives itself to be middle class. In a country such as Great Britain, however, the relative lack of class mobility and the differences between classes have resulted in the emergence of class consciousness. **Class consciousness** refers to a condition where people tend to perceive themselves in terms of their class background, and this shapes their relationships with members of other classes.

This has been played out in British society in the traditional hostility between upper-middle-class managers and their working-class employees. Mutual antagonism and lack of respect historically made it difficult to achieve cooperation between management and labor in many British companies and resulted in a relatively high level of industrial

disputes. However, the past two decades have seen a dramatic reduction in industrial disputes, which bolsters the arguments of those who claim that the country is moving toward a classless society (the level of industrial disputes in the United Kingdom is now lower than in the United States or Canada). Alternatively, as noted above, class consciousness may be reemerging in urban China, and it may ultimately prove to be significant there.

An antagonistic relationship between management and labor classes, and the resulting lack of cooperation and high level of industrial disruption, tends to raise the costs of production in countries characterized by significant class divisions. In turn, this can make it more difficult for companies based in such countries to establish a competitive advantage in the global economy.

Religious and Ethical Systems LO2

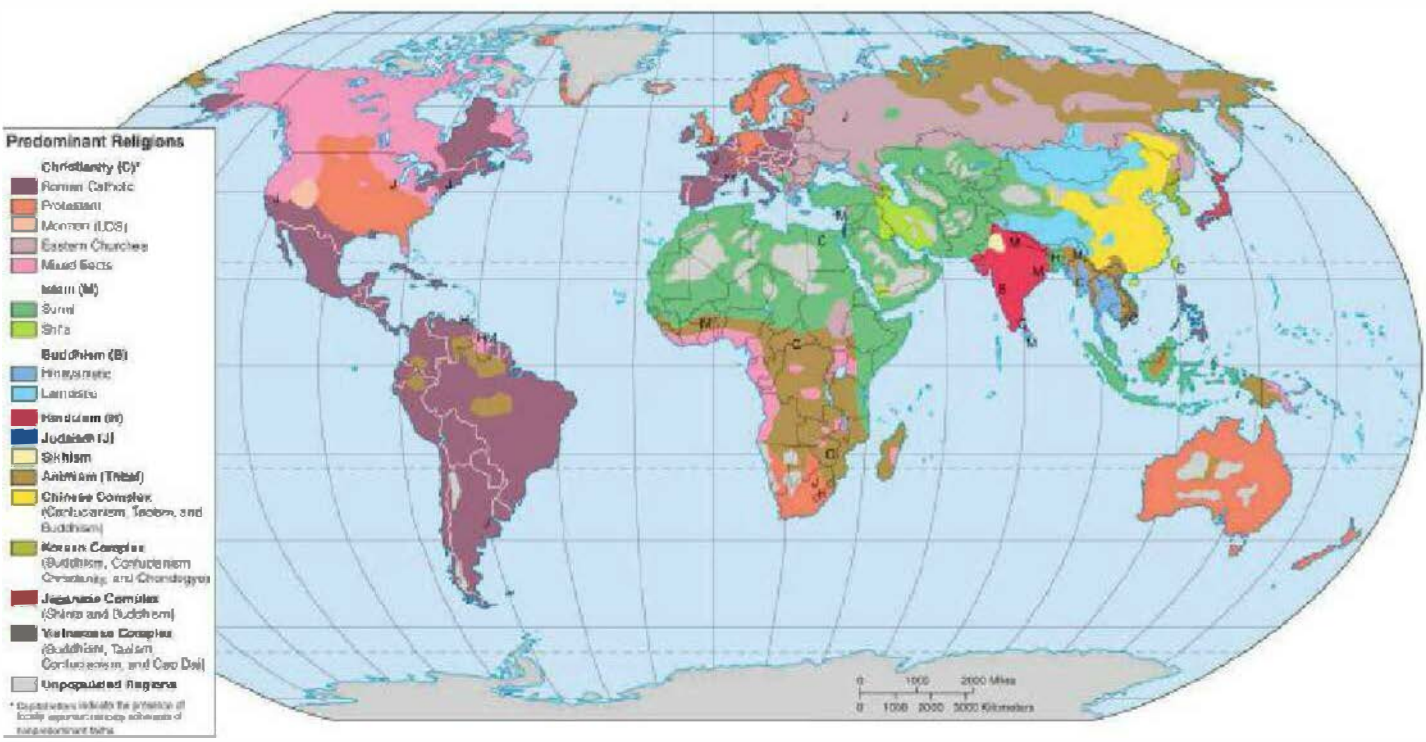
Religion may be defined as a system of shared beliefs and rituals that are concerned with the realm of the sacred.[26] **Ethical systems** refer to a set of moral principles, or values, that are used to guide and shape behavior. Most of the world's ethical systems are the product of religions. Thus, we can talk about Christian ethics and Islamic ethics. However, there is a major exception to the principle that ethical systems are grounded in religion. Confucianism and Confucian ethics influence behavior and shape culture in parts of Asia, yet it is incorrect to characterize Confucianism as a religion.

The relationship among religion, ethics, and society is subtle and complex. Among the thousands of religions in the world today, four dominate in terms of numbers of adherents: Christianity with roughly 1.9 billion adherents, Islam with around 1.2 billion adherents, Hinduism with 750 million adherents (primarily in India), and Buddhism with 350 million adherents (see Map 4.1). Although many other religions have an important influence in certain parts of the modern world (for example, Judaism, which has 18 million adherents), their numbers pale in comparison with these dominant religions (although as the precursor of both Christianity and Islam, Judaism has an indirect influence that goes beyond its numbers). We will review these four religions, along with Confucianism, focusing on their business implications. Some scholars have argued that the most important business implications of religion center on the extent to which different religions shape attitudes toward work and entrepreneurship and the degree to which the religious ethics affect the costs of doing business in a country.

It is hazardous to make sweeping generalizations about the nature of the relationship between religion and ethical systems and business practice. While some scholars argue that there is a relationship between religious and ethical systems and business practice in a society, in a world where nations with Catholic, Protestant, Muslim, Hindu, and Buddhist majorities all show evidence of entrepreneurial activity and sustainable economic growth, it is important to view such proposed relationships with a degree of skepticism. The proposed relationships may exist, but their impact may be small compared to the impact of economic policy. Recent research by economists Robert Barro and Rachel McCleary does suggest that strong religious beliefs, particularly beliefs in heaven, hell, and an afterlife, have a positive impact on economic growth rates, irrespective of the particular religion in question.[27] Barro and McCleary looked at religious beliefs and economic growth rates in 59 countries during the 1980s and 1990s. Their conjecture was that higher religious beliefs stimulate economic growth because they help to sustain aspects of individual behavior that lead to higher productivity.

CHRISTIANITY

Christianity is the most widely practiced religion in the world. Approximately 20 percent of the world's people identify themselves as Christians. The vast majority of Christians live in Europe and the Americas, although their numbers are growing rapidly in Africa. Christianity grew out of Judaism. Like Judaism, it is a monotheistic religion (monotheism is the belief in one god). A religious division in the eleventh century led to the



MAP 4.1

World Religions

Source: From John L. Allen, *Student Atlas of World Politics* 9th edition, 2008, Map 13. Copyright © 2008 by The McGraw-Hill Companies. Reproduced by permission of McGraw-Hill Contemporary Learning Series.

establishment of two major Christian organizations—the Roman Catholic Church and the Orthodox Church. Today, the Roman Catholic Church accounts for more than half of all Christians, most of whom are found in Southern Europe and Latin America. The Orthodox Church, while less influential, is still of major importance in several countries (e.g., Greece and Russia). In the sixteenth century, the Reformation led to a further split with Rome; the result was Protestantism. The nonconformist nature of Protestantism has facilitated the emergence of numerous denominations under the Protestant umbrella (e.g., Baptist, Methodist, Calvinist).

Economic Implications of Christianity: The Protestant Work Ethic LO3

Several sociologists have argued that of the main branches of Christianity—Catholic, Orthodox, and Protestant—the latter has the most important economic implications. In 1904, a German sociologist, Max Weber, made a connection between Protestant ethics and "the spirit of capitalism" that has since become famous.[28] Weber noted that capitalism emerged in Western Europe, where

> business leaders and owners of capital, as well as the higher grades of skilled labor, and even more the higher technically and commercially trained personnel of modern enterprises, are overwhelmingly Protestant.[29]

Weber theorized that there was a relationship between Protestantism and the emergence of modern capitalism. He argued that Protestant ethics emphasize the importance of hard work and wealth creation (for the glory of God) and frugality (abstinence from worldly pleasures). According to Weber, this kind of value system was needed to facilitate the development of capitalism. Protestants worked hard and systematically to accumulate wealth. However, their ascetic beliefs suggested that rather than consuming this wealth by indulging in worldly pleasures, they should invest it in the expansion of capitalist enterprises. Thus, the combination of hard work and the accumulation of capital, which could be used to finance investment and expansion, paved the way for the development of capitalism in Western Europe and subsequently in the United States. In contrast, Weber argued that the Catholic promise of salvation in the next world, rather than this world, did not foster the same kind of work ethic.

Protestantism also may have encouraged capitalism's development in another way. By breaking away from the hierarchical domination of religious and social life that characterized the Catholic Church for much of its history, Protestantism gave individuals significantly more freedom to develop their own relationship with God. The right to freedom of form of worship was central to the nonconformist nature of early Protestantism. This emphasis on individual religious freedom may have paved the way for the subsequent emphasis on individual economic and political freedoms and the development of individualism as an economic and political philosophy. As we saw in Chapter 2, such a philosophy forms the bedrock on which entrepreneurial free market capitalism is based. Building on this, some scholars claim there is a connection between individualism, as inspired by Protestantism, and the extent of entrepreneurial activity in a nation.[30] Again, one must be careful not to generalize too much from this historical sociological view. While nations with a strong Protestant tradition such as Britain, Germany, and the United States were early leaders in the industrial revolution, nations with Catholic or Orthodox majorities show significant and sustained entrepreneurial activity and economic growth in the modern world.

ISLAM LO2

With about 1.2 billion adherents, Islam is the second largest of the world's major religions. Islam dates back to AD 610 when the prophet Muhammad began spreading the word, although the Muslim calendar begins in AD 622 when, to escape growing opposition, Muhammad left Mecca for the oasis settlement of Yathrib, later known as Medina. Adherents of Islam are referred to as Muslims. Muslims constitute a majority in more

than 35 countries and inhabit a nearly contiguous stretch of land from the northwest coast of Africa, through the Middle East, to China and Malaysia in the Far East.

Islam has roots in both Judaism and Christianity (Islam views Jesus Christ as one of God's prophets). Like Christianity and Judaism, Islam is a monotheistic religion. The central principle of Islam is that there is but the one true omnipotent God. Islam requires unconditional acceptance of the uniqueness, power, and authority of God and the understanding that the objective of life is to fulfill the dictates of his will in the hope of admission to paradise. According to Islam, worldly gain and temporal power are an illusion. Those who pursue riches on earth may gain them, but those who forgo worldly ambitions to seek the favor of Allah may gain the greater treasure—entry into paradise. Other major principles of Islam include (1) honoring and respecting parents, (2) respecting the rights of others, (3) being generous but not a squanderer, (4) avoiding killing except for justifiable causes, (5) not committing adultery, (6) dealing justly and equitably with others, (7) being of pure heart and mind, (8) safeguarding the possessions of orphans, and (9) being humble and unpretentious.[31] Obvious parallels exist with many of the central principles of both Judaism and Christianity.

Islam is an all-embracing way of life governing the totality of a Muslim's being.[32] As God's surrogate in this world, a Muslim is not a totally free agent but is circumscribed by religious principles—by a code of conduct for interpersonal relations—in social and economic activities. Religion is paramount in all areas of life. The Muslim lives in a social structure that is shaped by Islamic values and norms of moral conduct. The ritual nature of everyday life in a Muslim country is striking to a Western visitor. Among other things, orthodox Muslim ritual requires prayer five times a day (business meetings may be put on hold while the Muslim participants engage in their daily prayer ritual), demands that women should be dressed in a certain manner, and forbids the consumption of pork and alcohol (see the opening case for a discussion of the Saudi example).

Islamic Fundamentalism

The past three decades have witnessed the growth of a social movement often referred to as Islamic fundamentalism.[33] In the West, Islamic fundamentalism is associated in the



The rise of Islamic fundamentalism as a reaction against globalization and the prevalence of Western cultural ideas has sent many scrambling to try to understand Muslim culture and promote greater dialogue.

media with militants, terrorists, and violent upheavals, such as the bloody conflict occurring in Algeria, the killing of foreign tourists in Egypt, and the September 11, 2001, attacks on the World Trade Center and Pentagon in the United States. This characterization is misleading. Just as Christian fundamentalists are motivated by sincere and deeply held religious values firmly rooted in their faith, so are Islamic fundamentalists. The violence that the Western media associates with Islamic fundamentalism is perpetrated by a small minority of radical "fundamentalists" who have hijacked the religion to further their own political and violent ends. (Some Christian "fundamentalists" have done exactly the same, including Jim Jones and David Koresh.) The vast majority of Muslims point out that Islam teaches peace, justice, and tolerance, not violence and intolerance, and that Islam explicitly repudiates the violence that a radical minority practices.

The rise of Islamic fundamentalism has no one cause. In part, it is a response to the social pressures created in traditional Islamic societies by the move toward modernization and by the influence of Western ideas, such as liberal democracy, materialism, equal rights for women, and attitudes toward sex, marriage, and alcohol. In many Muslim countries, modernization has been accompanied by a growing gap between a rich urban minority and an impoverished urban and rural majority. For the impoverished majority, modernization has offered little in the way of tangible economic progress, while threatening the traditional value system. Thus, for a Muslim who cherishes his or her traditions and feels that his or her identity is jeopardized by the encroachment of alien Western values, Islamic fundamentalism has become a cultural anchor.

Fundamentalists demand commitment to traditional religious beliefs and rituals. The result has been a marked increase in the use of symbolic gestures that confirm Islamic values. In areas where fundamentalism is strong, women have resumed wearing floor-length, long-sleeved dresses and covering their hair; religious studies have increased in universities; the publication of religious tracts has increased; and public religious orations have risen.[34] Also, the sentiments of some fundamentalist groups are often anti-Western. Rightly or wrongly, Western influence is blamed for a range of social ills, and many fundamentalists' actions are directed against Western governments, cultural symbols, businesses, and even individuals.

In several Muslim countries, fundamentalists have gained political power and have used this to try to make Islamic law (as set down in the Koran, the bible of Islam) the law of the land. There are grounds for this in Islam doctrine. Islam makes no distinction between church and state. It is not just a religion; Islam is also the source of law, a guide to statecraft, and an arbiter of social behavior. Muslims believe that every human endeavor is within the purview of the faith—and this includes political activity—because the only purpose of any activity is to do God's will.[35] (Some Christian fundamentalists also share this view.) Muslim fundamentalists have been most successful in Iran, where a fundamentalist party has held power since 1979, but they also have had an influence in many other countries, such as Afghanistan (where the Taliban established an extreme fundamentalist state until removed by the U.S.-led coalition in 2002), Algeria, Egypt, Pakistan, Saudi Arabia, and the Sudan.

Economic Implications of Islam LO3

The Koran establishes some explicit economic principles, many of which are pro-free enterprise.[36] The Koran speaks approvingly of free enterprise and of earning legitimate profit through trade and commerce (the prophet Mohammed himself was once a trader). The protection of the right to private property is also embedded within Islam, although Islam asserts that all property is a favor from Allah (God), who created and so owns everything. Those who hold property are regarded as trustees rather than owners in the Western sense of the word. As trustees they are entitled to receive profits from the property but are admonished to use it in a righteous, socially beneficial, and prudent manner. This reflects Islam's concern with social justice. Islam is critical of those who earn profit through the exploitation of others. In the Islamic view of the world, humans are part of a collective in which the wealthy and successful have obligations to help the disadvantaged. Put simply, in Muslim countries, it is fine to earn a profit, so long as that profit is justly earned and not

based on the exploitation of others for one's own advantage. It also helps if those making profits undertake charitable acts to help the poor. Furthermore, Islam stresses the importance of living up to contractual obligations, of keeping one's word, and of abstaining from deception. For a closer look at how Islam, capitalism, and globalization can coexist, see the accompanying Country Focus about the region around Kayseri in central Turkey.

Given the Islamic proclivity to favor market-based systems, Muslim countries are likely to be receptive to international businesses as long as those businesses behave in a manner that is consistent with Islamic ethics. Businesses that are perceived as making an unjust profit through the exploitation of others, by deception, or by breaking contractual obligations are unlikely to be welcomed in an Islamic country. In addition, in Islamic countries where fundamentalism is on the rise, hostility toward Western-owned businesses is likely to increase.

One economic principle of Islam prohibits the payment or receipt of interest, which is considered usury. This is not just a matter of theology; in several Islamic states, it is also a matter of law. The Koran clearly condemns interest, which is called *riba* in Arabic, as exploitative and unjust. For many years, banks operating in Islamic countries conveniently ignored this condemnation, but starting about 30 years ago with the establishment of an Islamic bank in Egypt, Islamic banks started to open in predominantly Muslim countries. By 2009, more than 300 Islamic banks in over 50 countries had assets of around $400 billion, while another $800 billion was managed by mutual funds that adhered to Islamic principles.[38] Even conventional banks are entering the market—both Citigroup and HSBC, two of the world's largest financial institutions, now offer Islamic financial services. While only Iran and the Sudan enforce Islamic banking conventions, in an increasing number of countries customers can choose between conventional banks and Islamic banks.

Conventional banks make a profit on the spread between the interest rate they have to pay to depositors and the higher interest rate they charge borrowers. Because Islamic banks cannot pay or charge interest, they must find a different way of making money. Islamic banks have experimented with two different banking methods—the *mudarabah* and the *murabaha*.[39]

A *mudarabah* contract is similar to a profit-sharing scheme. Under *mudarabah*, when an Islamic bank lends money to a business, rather than charging that business interest on the loan, it takes a share in the profits that are derived from the investment. Similarly, when a business (or individual) deposits money at an Islamic bank in a savings account, the deposit is treated as an equity investment in whatever activity the bank uses the capital for. Thus, the depositor receives a share in the profit from the bank's investment (as opposed to interest payments) according to an agreed-on ratio. Some Muslims claim this is a more efficient system than the Western banking system, since it encourages both long-term savings and long-term investment. However, there is no hard evidence of this, and many believe that a *mudarabah* system is less efficient than a conventional Western banking system.

The second Islamic banking method, the *murabaha* contract, is the most widely used among the world's Islamic banks, primarily because it is the easiest to implement. In a *murabaha* contract, when a firm wishes to purchase something using a loan—let's say a piece of equipment that costs $1,000—the firm tells the bank after having negotiated the price with the equipment manufacturer. The bank then buys the equipment for $1,000, and the borrower buys it back from the bank at some later date for, say, $1,100, a price that includes a $100 markup for the bank. A cynic might point out that such a markup is functionally equivalent to an interest payment, and it is the similarity between this method and conventional banking that makes it so much easier to adopt.

LO2 HINDUISM

Hinduism has approximately 750 million adherents, most of them on the Indian subcontinent. Hinduism began in the Indus Valley in India more than 4,000 years ago, making it the world's oldest major religion. Unlike Christianity and Islam, its founding is not



COUNTRY FOCUS

Islamic Capitalism in Turkey

For years now Turkey has been lobbying the European Union to allow it to join the free trade bloc as a member state. If the EU says yes, it will be the first Muslim state in the union. Many critics in the EU worry that Islam and Western-style capitalism do not mix well, and that as a consequence, allowing Turkey into the EU would be a mistake. However, a close look at what is going on in Turkey suggests this view may be misplaced. Consider the area around the city of Kayseri in central Turkey. Many dismiss this poor, largely agricultural region of Turkey as a non-European backwater, far removed from the secular bustle of Istanbul. It is a region where traditional Islamic values hold sway. And yet, it is also a region that has produced so many thriving Muslim enterprises that it is sometimes called the "Anatolian Tiger." Businesses based here include large food manufacturers, textile companies, furniture manufacturers, and engineering enterprises, many of which export a substantial percentage of their production.

Local business leaders attribute the success of companies in the region to an entrepreneurial spirit that they say is part of Islam. They point out that the Prophet Muhammad, who was himself a trader, preached merchant honor and commanded that 90 percent of a Muslim's life be devoted to work in order to put food on the table. Outsider observers have gone further, arguing that what is occurring around Kayseri is an example of Islamic Calvinism, a fusion of traditional Islamic values and the work ethic often associated with Protestantism in general and Calvinism in particular.

Within Kayseri, the influence of Islam is plain to see. Many companies set aside rooms and time for 15-minute prayer breaks. Most of the older businessmen have been to Mecca on the pilgrimage that all Muslims are meant to make at least once in a lifetime. Few of the cafés and restaurants in Kayseri serve alcohol, and most women wear a head scarf.

At the Kayseri sugar factory, one of the most profitable in the region, a senior manager says Islam has played a large part in improving the profitability of the enterprise. For a long time the factory bought most of its sugar beet from a single monopoly supplier, who charged a high price. But because Islam preaches equal opportunity in business, managers at the sugar factory decided the Islamic thing to do was diversify the supply base and encourage small producers to sell beets to them. Today the factory buys sugar beets from 20,000 small growers. Competition between them has lowered prices and boosted the factory's profitability. The same manager also noted, "If you are not a good Muslim, don't pray five times a day, and don't have a wife who wears a head scarf, it can be difficult to do business here."

However, not everyone agrees that Islam is the driving force behind the region's success. Saffet Arslan, the managing director of Ipek, the largest furniture producer in the region (which exports to more than 30 countries), says another force is at work—globalization! According to Arslan, over the past three decades local Muslims who once eschewed making money in favor of focusing on religion are now making business a priority. They see the Western world, and Western capitalism, as a model, not Islam, and because of globalization and the opportunities associated with it, they want to become successful. At the same time, Arslan is a practicing Muslim who has built a mosque in the basement of Ipec's headquarters building so that people can pray while at work.

If there is a weakness in the Islamic model of business that is emerging in places such as Kayseri, some say it can be found in traditional attitudes toward the role of women in the workplace, and the low level of female employment in the region. According to a report by the European Stability Initiative, the same group that holds up the Kayseri region as an example of Islamic Calvinism, the low participation of women in the local workforce is the Achilles' heel of the economy and may stymie the attempts of the region to catch up with the countries of the European Union.[37]

linked to a particular person. Nor does it have an officially sanctioned sacred book such as the Bible or the Koran. Hindus believe that a moral force in society requires the acceptance of certain responsibilities, called *dharma*. Hindus believe in reincarnation, or rebirth into a different body, after death. Hindus also believe in *karma*, the spiritual progression of each person's soul. A person's karma is affected by the way he or she lives. The moral state of an individual's karma determines the challenges he or she will face in

the next life. By perfecting the soul in each new life, Hindus believe that an individual can eventually achieve *nirvana*, a state of complete spiritual perfection that renders reincarnation no longer necessary. Many Hindus believe that the way to achieve nirvana is to lead a severe ascetic lifestyle of material and physical self-denial, devoting life to a spiritual rather than material quest.

LO3 Economic Implications of Hinduism

Max Weber, famous for expounding on the Protestant work ethic, also argued that the ascetic principles embedded in Hinduism do not encourage the kind of entrepreneurial activity in pursuit of wealth creation that we find in Protestantism.[40] According to Weber, traditional Hindu values emphasize that individuals should be judged not by their material achievements but by their spiritual achievements. Hindus perceive the pursuit of material well-being as making the attainment of nirvana more difficult. Given the emphasis on an ascetic lifestyle, Weber thought that devout Hindus would be less likely to engage in entrepreneurial activity than devout Protestants.

Mahatma Gandhi, the famous Indian nationalist and spiritual leader, was certainly the embodiment of Hindu asceticism. It has been argued that the values of Hindu asceticism and self-reliance that Gandhi advocated had a negative impact on the economic development of postindependence India.[41] But one must be careful not to read too much into Weber's arguments. Modern India is a very dynamic entrepreneurial society, and millions of hardworking entrepreneurs form the economic backbone of the country's rapidly growing economy.

Historically, Hinduism also supported India's caste system. The concept of mobility between castes within an individual's lifetime makes no sense to traditional Hindus. Hindus see mobility between castes as something that is achieved through spiritual progression and reincarnation. An individual can be reborn into a higher caste in his or her next life if he or she achieves spiritual development in this life. Although the caste system has been abolished in India, it still casts a long shadow over Indian life, according to many observers. Insofar as the caste system limits individuals' opportunities to adopt positions of responsibility and influence in society, the economic consequences of this religious belief are somewhat negative. For example, within a business organization, the most able individuals may find their route to the higher levels of the organization blocked simply because they come from a lower caste. By the same token, individuals may get promoted to higher positions within a firm as much because of their caste background as because of their ability.

LO2 BUDDHISM

Buddhism was founded in India in the sixth century BC by Siddhartha Gautama, an Indian prince who renounced his wealth to pursue an ascetic lifestyle and spiritual perfection. Siddhartha achieved nirvana but decided to remain on earth to teach his followers how they too could achieve this state of spiritual enlightenment. Siddhartha became known as the Buddha (which means "the awakened one"). Today, Buddhism has 350 million followers, most of whom are found in Central and Southeast Asia, China, Korea, and Japan. According to Buddhism, suffering originates in people's desires for pleasure. Cessation of suffering can be achieved by following a path for transformation. Siddhartha offered the Noble Eightfold Path as a route for transformation. This emphasizes right seeing, thinking, speech, action, living, effort, mindfulness, and meditation. Unlike Hinduism, Buddhism does not support the caste system. Nor does Buddhism advocate the kind of extreme ascetic behavior that is encouraged by Hinduism. Nevertheless, like Hindus, Buddhists stress the afterlife and spiritual achievement rather than involvement in this world.

LO3 Economic Implications of Buddhism

The emphasis on wealth creation that is embedded in Protestantism is not found in Buddhism. Thus, in Buddhist societies, we do not see the same kind of historical cultural stress on entrepreneurial behavior that Weber claimed could be found in the Protestant

West. But unlike Hinduism, the lack of support for the caste system and extreme ascetic behavior suggests that a Buddhist society may represent a more fertile ground for entrepreneurial activity than a Hindu culture.

CONFUCIANISM LO2

Confucianism was founded in the fifth century BC by K'ung-Fu-tzu, more generally known as Confucius. For more than 2,000 years until the 1949 Communist revolution, Confucianism was the official ethical system of China. While observance of Confucian ethics has been weakened in China since 1949, more than 200 million people still follow the teachings of Confucius, principally in China, Korea, and Japan. Confucianism teaches the importance of attaining personal salvation through right action. Although not a religion, Confucian ideology has become deeply embedded in the culture of these countries over the centuries, and through that, has an impact on the lives of many millions more. Confucianism is built around a comprehensive ethical code that sets down guidelines for relationships with others. High moral and ethical conduct and loyalty to others are central to Confucianism. Unlike religions, Confucianism is not concerned with the supernatural and has little to say about the concept of a supreme being or an afterlife.

Economic Implications of Confucianism LO3

Some scholars maintain that Confucianism may have economic implications as profound as those Weber argued were to be found in Protestantism, although they are of a different nature.[42] Their basic thesis is that the influence of Confucian ethics on the culture of China, Japan, South Korea, and Taiwan, by lowering the costs of doing business in those countries, may help explain their economic success. In this regard, three values central to the Confucian system of ethics are of particular interest: loyalty, reciprocal obligations, and honesty in dealings with others.

In Confucian thought, loyalty to one's superiors is regarded as a sacred duty—an absolute obligation. In modern organizations based in Confucian cultures, the loyalty that binds employees to the heads of their organization can reduce the conflict between management and labor that we find in more class-conscious societies. Cooperation between management and labor can be achieved at a lower cost in a culture where the virtue of loyalty is emphasized in the value systems.

However, in a Confucian culture, loyalty to one's superiors, such as a worker's loyalty to management, is not blind loyalty. The concept of reciprocal obligations is important. Confucian ethics stress that superiors are obliged to reward the loyalty of their subordinates by bestowing blessings on them. If these "blessings" are not forthcoming, then neither will be the loyalty. This Confucian ethic is central to the Chinese concept of *guanxi*, which refers to relationship networks supported by reciprocal obligations.[43] *Guanxi* means relationships, although in business settings it can be better understood as connections. Today, Chinese will often cultivate a *guanxiwang*, or "relationship network," for help. Reciprocal obligations are the glue that holds such networks together. If those obligations are not met—if favors done are not paid back or reciprocated—the reputation of the transgressor is tarnished and the person will be less able to draw on his or her *guanxiwang* for help in the future. Thus, the implicit threat of social sanctions is often sufficient to ensure that favors are repaid, obligations are met, and relationships are honored. In a society that lacks a rule-based legal tradition, and thus legal ways of redressing wrongs such as violations of business agreements, *guanxi* is an important mechanism for building long-term business relationships and getting business done in China. For an example of the importance of *guanxi*, read the Management Focus on DMG-Shanghai.

A third concept found in Confucian ethics is the importance attached to honesty. Confucian thinkers emphasize that, although dishonest behavior may yield short-term benefits for the transgressor, dishonesty does not pay in the long run. The importance attached to honesty has major economic implications. When companies can trust each other not to break contractual obligations, the costs of doing business are lowered.

Expensive lawyers are not needed to resolve contract disputes. In a Confucian society, people may be less hesitant to commit substantial resources to cooperative ventures than in a society where honesty is less pervasive. When companies adhere to Confucian ethics, they can trust each other not to violate the terms of cooperative agreements. Thus, the costs of achieving cooperation between companies may be lower in societies such as Japan relative to societies where trust is less pervasive.

For example, it has been argued that the close ties between the automobile companies and their component parts suppliers in Japan are facilitated by a combination of trust and reciprocal obligations. These close ties allow the auto companies and their suppliers to work together on a range of issues, including inventory reduction, quality control, and design. The competitive advantage of Japanese auto companies such as Toyota may in part be explained by such factors.[44] Similarly, the combination of trust and reciprocal obligations is central to the workings and persistence of *guanxi* networks in China. Someone seeking and receiving help through a *guanxi* network is then obligated to return the favor and faces social sanctions if that obligation is not reciprocated when it is called upon. If the person does not return the favor, his or her reputation will be tarnished and he or she will be unable to draw on the resources of the network in the future. It is claimed that these relationship-based networks can be more important in helping to enforce agreements between businesses than the Chinese legal system. Some claim that *guanxi* networks are a substitute for the legal system.[45]

LO2 Language

One obvious way in which countries differ is language. By language, we mean both the spoken and the unspoken means of communication. Language is one of the defining characteristics of a culture.

SPOKEN LANGUAGE

Language does far more than just enable people to communicate with each other. The nature of a language also structures the way we perceive the world. The language of a society can direct the attention of its members to certain features of the world rather than others. The classic illustration of this phenomenon is that whereas the English language has but one word for snow, the language of the Inuit (Eskimos) lacks a general term for it. Instead, because distinguishing different forms of snow is so important in the lives of the Inuit, they have 24 words that describe different types of snow (e.g., powder snow, falling snow, wet snow, drifting snow).[47]

Because language shapes the way people perceive the world, it also helps define culture. Countries with more than one language often have more than one culture. Canada has an English-speaking culture and a French-speaking culture. Tensions between the two can run quite high, with a substantial proportion of the French-speaking minority demanding independence from a Canada "dominated by English speakers." The same phenomenon can be observed in many other countries. Belgium is divided into Flemish and French speakers, and tensions between the two groups exist; in Spain, a Basque-speaking minority with its own distinctive culture has been agitating for independence from the Spanish-speaking majority for decades; on the Mediterranean island of Cyprus, the culturally diverse Greek- and Turkish-speaking populations of the island engaged in open conflict in the 1970s, and the island is now partitioned into two parts. While it does not necessarily follow that language differences create differences in culture and, therefore, separatist



Language is primary to establishing quality business relationships.

MANAGEMENT FOCUS

DMG-Shanghai

In 1993, New Yorker Dan Mintz moved to China as a freelance film director with no contacts, no advertising experience, and no Mandarin skills. By 2006, the company he subsequently founded in China, DMG, had emerged as one of China's fastest-growing advertising agencies with a client list that includes Budweiser, Unilever, Sony, Nabisco, Audi, Volkswagen, China Mobile, and dozens of other Chinese brands. Mintz attributes his success in part to what the Chinese call *guanxi*.

Guanxi literally means relationships, although in business settings it can be better understood as connections. *Guanxi* has its roots in the Confucian philosophy of valuing social hierarchy and reciprocal obligations. Confucian ideology has a 2,000-year-old history in China. Confucianism stresses the importance of relationships, both within the family and between master and servant. Confucian ideology teaches that people are not created equal. In Confucian thought, loyalty and obligations to one's superiors (or to family) is regarded as a sacred duty, but at the same time, this loyalty has its price. Social superiors are obligated to reward the loyalty of their social inferiors by bestowing "blessings" upon them; thus, the obligations are reciprocal.

Today, Chinese will often cultivate a *guanxiwang,* or "relationship network," for help. Reciprocal obligations are the glue that holds such networks together. If those obligations are not met—if favors done are not paid back or reciprocated—the reputation of the transgressor is tarnished, and he or she will be less able to draw on his or her *guanxiwang* for help in the future. Thus, the implicit threat of social sanctions is often sufficient to ensure that favors are repaid, obligations are met, and relationships are honored. In a society that lacks a strong rule-based legal tradition, and thus legal ways of redressing wrongs such as violations of business agreements, *guanxi* is an important mechanism for building long-term business relationships and getting business done in China. There is a tacit acknowledgment that if you have the right *guanxi,* legal rules can be broken, or at least bent.

Mintz, who is now fluent in Mandarin, cultivated his *guanxiwang* by going into business with two young Chinese who had connections, Bing Wu and Peter Xiao. Bing Wu, who works on the production side of the business, was a former national gymnastics champion, which translates into prestige and access to business and government officials. Peter Xiao comes from a military family with major political connections. Together, these three have been able to open doors that long-established Western advertising agencies have not. They have done it in large part by leveraging the contacts of Wu and Xiao, and by backing up their connections with what the Chinese call *Shi li,* the ability to do good work.

A case in point was DMG's campaign for Volkswagen, which helped the German company to become ubiquitous in China. The ads used traditional Chinese characters, which had been banned by Chairman Mao during the cultural revolution in favor of simplified versions. To get permission to use the characters in film and print ads—a first in modern China—the trio had to draw on high-level government contacts in Beijing. They won over officials by arguing that the old characters should be thought of not as "characters" but as art. Later, they shot TV spots for the ad on Shanghai's famous Bund, a congested boulevard that runs along the waterfront of the old city. Drawing again on government contacts, they were able to shut down the Bund to make the shoot. Steven Spielberg had been able to close down only a portion of the street when he filmed *Empire of the Sun* there in 1986. DMG has also filmed inside Beijing's Forbidden City, even though it is against the law to do so. Using his contacts, Mintz persuaded the government to lift the law for 24 hours. As Mintz has noted, "We don't stop when we come across regulations. There are restrictions everywhere you go. You have to know how get around them and get things done."[46]

pressures (e.g., witness the harmony in Switzerland, where four languages are spoken), there certainly seems to be a tendency in this direction.[48]

Chinese is the mother tongue of the largest number of people, followed by English and Hindi, which is spoken in India. However, the most widely spoken language in the world is English, followed by French, Spanish, and Chinese (i.e., many people speak English as a second language). English is increasingly becoming the language of international business. When a Japanese and a German businessperson get together to

do business, it is almost certain that they will communicate in English. However, although English is widely used, learning the local language yields considerable advantages. Most people prefer to converse in their own language, and being able to speak the local language can build rapport, which may be very important for a business deal. International businesses that do not understand the local language can make major blunders through improper translation. For example, the Sunbeam Corporation used the English words for its "Mist-Stick" mist-producing hair curling iron when it entered the German market, only to discover after an expensive advertising campaign that *mist* means excrement in German. General Motors was troubled by the lack of enthusiasm among Puerto Rican dealers for its new Chevrolet Nova. When literally translated into Spanish, *nova* means star. However, when spoken it sounds like "no va," which in Spanish means "it doesn't go." General Motors changed the name of the car to Caribe.[49]

LO² UNSPOKEN LANGUAGE

Unspoken language refers to nonverbal communication. We all communicate with each other by a host of nonverbal cues. The raising of eyebrows, for example, is a sign of recognition in most cultures, while a smile is a sign of joy. Many nonverbal cues, however, are culturally bound. A failure to understand the nonverbal cues of another culture can lead to a communication failure. For example, making a circle with the thumb and the forefinger is a friendly gesture in the United States, but it is a vulgar sexual invitation in Greece and Turkey. Similarly, while most Americans and Europeans use the thumbs-up gesture to indicate that "it's all right," in Greece the gesture is obscene.

Another aspect of nonverbal communication is personal space, which is the comfortable amount of distance between you and someone you are talking with. In the United States, the customary distance apart adopted by parties in a business discussion is five to eight feet. In Latin America, it is three to five feet. Consequently, many North Americans unconsciously feel that Latin Americans are invading their personal space and can be seen backing away from them during a conversation. Indeed, the American may feel that the Latin is being aggressive and pushy. In turn, the Latin American may interpret such backing away as aloofness. The result can be a regrettable lack of rapport between two businesspeople from different cultures.

LO² Education

Formal education plays a key role in a society. Formal education is the medium through which individuals learn many of the language, conceptual, and mathematical skills that are indispensable in a modern society. Formal education also supplements the family's role in socializing the young into the values and norms of a society. Values and norms are taught both directly and indirectly. Schools generally teach basic facts about the social and political nature of a society. They also focus on the fundamental obligations of citizenship. Cultural norms are also taught indirectly at school. Respect for others, obedience to authority, honesty, neatness, being on time, and so on, are all part of the "hidden curriculum" of schools. The use of a grading system also teaches children the value of personal achievement and competition.[50]

From an international business perspective, one important aspect of education is its role as a determinant of national competitive advantage.[51] The availability of a pool of skilled and educated workers seems to be a major determinant of the likely economic success of a country. In analyzing the competitive success of Japan since 1945, for example, Michael Porter notes that after the war, Japan had almost nothing except for a pool of skilled and educated human resources.

> With a long tradition of respect for education that borders on reverence, Japan possessed a large pool of literate, educated, and increasingly skilled human resources. . . . Japan has

> benefited from a large pool of trained engineers. Japanese universities graduate many more engineers per capita than in the United States. . . . A first-rate primary and secondary education system in Japan operates based on high standards and emphasizes math and science. Primary and secondary education is highly competitive. . . . Japanese education provides most students all over Japan with a sound education for later education and training. A Japanese high school graduate knows as much about math as most American college graduates.[52]

Porter's point is that Japan's excellent education system is an important factor explaining the country's postwar economic success. Not only is a good education system a determinant of national competitive advantage, but it is also an important factor guiding the location choices of international businesses. The recent trend to outsource information technology jobs to India, for example, is partly due to the presence of significant numbers of trained engineers in India, which in turn is a result of the Indian education system. By the same token, it would make little sense to base production facilities that require highly skilled labor in a country where the education system was so poor that a skilled labor pool wasn't available, no matter how attractive the country might seem on other dimensions. It might make sense to base production operations that require only unskilled labor in such a country.

The general education level of a country is also a good index of the kind of products that might sell in a country and of the type of promotional material that should be used. For example, a country where more than 70 percent of the population is illiterate is unlikely to be a good market for popular books. Promotional material containing written descriptions of mass-marketed products is unlikely to have an effect in a country where almost three-quarters of the population cannot read. It is far better to use pictorial promotions in such circumstances.

Culture and the Workplace

LO4

Of considerable importance for an international business with operations in different countries is how a society's culture affects the values found in the workplace. Management process and practices may need to vary according to culturally determined work-related values. For example, if the cultures of the United States and France result in different work-related values, an international business with operations in both countries should vary its management process and practices to account for these differences.

Probably the most famous study of how culture relates to values in the workplace was undertaken by Geert Hofstede.[53] As part of his job as a psychologist working for IBM, Hofstede collected data on employee attitudes and values for more than 100,000 individuals from 1967 to 1973. These data enabled him to compare dimensions of culture across 40 countries. Hofstede isolated four dimensions that he claimed summarized different cultures—power distance, uncertainty avoidance, individualism versus collectivism, and masculinity versus femininity.

Hofstede's **power distance** dimension focused on how a society deals with the fact that people are unequal in physical and intellectual capabilities. According to Hofstede, high power distance cultures were found in countries that let inequalities grow over time into inequalities of power and wealth. Low power distance cultures were found in societies that tried to play down such inequalities as much as possible.

The **individualism versus collectivism** dimension focused on the relationship between the individual and his or her fellows. In individualistic societies, the ties between individuals were loose and individual achievement and freedom were highly valued. In societies where collectivism was emphasized, the ties between individuals were tight. In such societies, people were born into collectives, such as extended families, and everyone was supposed to look after the interest of his or her collective.

Hofstede's **uncertainty avoidance** dimension measured the extent to which different cultures socialized their members into accepting ambiguous situations and tolerating

uncertainty. Members of high uncertainty avoidance cultures placed a premium on job security, career patterns, retirement benefits, and so on. They also had a strong need for rules and regulations; the manager was expected to issue clear instructions, and subordinates' initiatives were tightly controlled. Lower uncertainty avoidance cultures were characterized by a greater readiness to take risks and less emotional resistance to change.

Hofstede's **masculinity versus femininity** dimension looked at the relationship between gender and work roles. In masculine cultures, sex roles were sharply differentiated and traditional "masculine values," such as achievement and the effective exercise of power, determined cultural ideals. In feminine cultures, sex roles were less sharply distinguished, and little differentiation was made between men and women in the same job.

Hofstede created an index score for each of these four dimensions that ranged from 0 to 100 and scored high for high individualism, high power distance, high uncertainty avoidance, and high masculinity. He averaged the score for all employees from a given country. Table 4.1 summarizes these data for 20 selected countries. Western nations such as the United States, Canada, and Britain score high on the individualism scale and low on the power distance scale. At the other extreme are a group of Latin American and Asian countries that emphasize collectivism over individualism and score high on the power distance scale. Table 4.1 also reveals that Japan's culture has strong uncertainty avoidance and high masculinity. This characterization fits the standard stereotype of Japan as a country that is male dominant and where uncertainty avoidance exhibits itself in the institution of lifetime employment. Sweden and Denmark stand out as countries

TABLE 4.1

Work-Related Values for 20 Selected Countries

Source: Cited in G. Hofstede, "The Cultural Relativity of Organizational Practices and Theories," *Journal of International Business Studies* 14 (Fall 1983), pp. 75–89. Reprinted by permission of Dr. Hofstede.

	Power Distance	Uncertainty Avoidance	Individualism	Masculinity
Argentina	49	86	46	56
Australia	36	51	90	61
Brazil	69	76	38	49
Canada	39	48	80	52
Denmark	18	23	74	16
France	68	86	71	43
Germany (F.R.)	35	65	67	66
Great Britain	35	35	89	66
India	77	40	48	56
Indonesia	78	48	14	46
Israel	13	81	54	47
Japan	54	92	46	95
Mexico	81	82	30	69
Netherlands	38	53	80	14
Panama	95	86	11	44
Spain	57	86	51	42
Sweden	31	29	71	5
Thailand	64	64	20	34
Turkey	66	85	37	45
United States	40	46	91	62

that have both low uncertainty avoidance and low masculinity (high emphasis on "feminine" values).

Hofstede's results are interesting for what they tell us in a very general way about differences between cultures. Many of Hofstede's findings are consistent with standard Western stereotypes about cultural differences. For example, many people believe Americans are more individualistic and egalitarian than the Japanese (they have a lower power distance), who in turn are more individualistic and egalitarian than Mexicans. Similarly, many might agree that Latin countries such as Mexico place a higher emphasis on masculine value—they are machismo cultures—than the Nordic countries of Denmark and Sweden.

However, one should be careful about reading too much into Hofstede's research. It has been criticized on a number of points.[54] First, Hofstede assumes there is a one-to-one correspondence between culture and the nation-state, but as we saw earlier, many countries have more than one culture. Hofstede's results do not capture this distinction. Second, the research may have been culturally bound. The research team was composed of Europeans and Americans. The questions they asked of IBM employees and their analysis of the answers may have been shaped by their own cultural biases and concerns. So it is not surprising that Hofstede's results confirm Western stereotypes, because it was Westerners who undertook the research.

Third, Hofstede's informants worked not only within a single industry, the computer industry, but also within one company, IBM. At the time, IBM was renowned for its own strong corporate culture and employee selection procedures, making it possible that the employees' values were different in important respects from the values of the cultures from which those employees came. Also, certain social classes (such as unskilled manual workers) were excluded from Hofstede's sample. A final caution is that Hofstede's work is now beginning to look dated. Cultures do not stand still; they evolve, albeit slowly. What was a reasonable characterization in the 1960s and 1970s may not be so today.

Still, just as it should not be accepted without question, Hofstede's work should not be dismissed either. It represents a starting point for managers trying to figure out how cultures differ and what that might mean for management practices. Also, several other scholars have found strong evidence that differences in culture affect values and practices in the workplace, and Hofstede's basic results have been replicated using more diverse samples of individuals in different settings.[55] Still, managers should use the results with caution, for they are not necessarily accurate.

Hofstede subsequently expanded his original research to include a fifth dimension that he argued captured additional cultural differences not brought out in his earlier work.[56] He referred to this dimension as "Confucian dynamism" (sometimes called *long-term orientation*). According to Hofstede, **Confucian dynamism** captures attitudes toward time, persistence, ordering by status, protection of face, respect for tradition, and reciprocation of gifts and favors. The label refers to these "values" being derived from Confucian teachings. As might be expected, East Asian countries such as Japan, Hong Kong, and Thailand scored high on Confucian dynamism, while nations such as the United States and Canada scored low. Hofstede and his associates went on to argue that their evidence suggested that nations with higher economic growth rates scored high on Confucian dynamism and low on individualism—the implication being Confucianism is good for growth. However, subsequent studies have shown that this finding does not hold up under more sophisticated statistical analysis.[57] During the past decade, countries with high individualism and low Confucian dynamics such as the United States have attained high growth rates, while some Confucian cultures such as Japan have had stagnant economic growth. In reality, while culture might influence the economic success of a nation, it is just one of many factors, and while its importance should not be ignored, it should not be overstated either. The factors discussed in Chapter 2—economic, political, and legal systems—are probably more important than culture in explaining differential economic growth rates over time.

LO5 Cultural Change

Culture is not a constant; it evolves over time.[58] Changes in value systems can be slow and painful for a society. In the 1960s, for example, American values toward the role of women, love, sex, and marriage underwent significant changes. Much of the social turmoil of that time reflected these changes. Change, however, does occur and can often be quite profound. For example, at the beginning of the 1960s, the idea that women might hold senior management positions in major corporations was not widely accepted. Many scoffed at the idea. Today, it is a reality, and few in the mainstream of American society question the development or the capability of women in the business world. American culture has changed (although it is still more difficult for women to gain senior management positions than men). Similarly, the value systems of many ex-communist states, such as Russia, are undergoing significant changes as those countries move away from values that emphasize collectivism and toward those that emphasize individualism. While social turmoil is an inevitable outcome of such a shift, the shift will still probably occur.

Similarly, some claim that a major cultural shift has been occurring in Japan, with a move toward greater individualism.[59] The model Japanese office worker, or "salaryman," is characterized as being loyal to his boss and the organization to the point of giving up evenings, weekends, and vacations to serve the organization, which is the collective of which the employee is a member. However, some argue that a new generation of office workers does not seem to fit this model. An individual from the new generation is likely to be more direct than the traditional Japanese. He acts more like a Westerner, a *gaijian*. He does not live for the company and will move on if he gets the offer of a better job. He is not keen on overtime, especially if he has a date. He has his own plans for his free time, and they may not include drinking or playing golf with the boss.[60]

Several studies have suggested that economic advancement and globalization may be important factors in societal change.[61] For example, there is evidence that economic progress is accompanied by a shift in values away from collectivism and toward individualism.[62] Thus, as Japan has become richer, the cultural emphasis on collectivism has declined and greater individualism is being witnessed. One reason for this shift may be that richer societies exhibit less need for social and material support structures built on collectives, whether the collective is the extended family or the paternalistic company. People are better able to take care of their own needs. As a result, the importance attached to collectivism declines, while greater economic freedoms lead to an increase in opportunities for expressing individualism.

The culture of societies may also change as they become richer because economic progress affects a number of other factors, which in turn influence culture. For example, increased urbanization and improvements in the quality and availability of education are both a function of economic progress, and both can lead to declining emphasis on the traditional values associated with poor rural societies. A 25-year study of values in 78 countries, known as the World Values Survey, coordinated by the University of Michigan's Institute for Social Research, has documented how values change. The study linked these changes in values to changes in a country's level of economic development.[63] According to this research, as countries get richer, a shift occurs away from "traditional values" linked to religion, family, and country, and toward "secular rational" values. Traditionalists say religion is important in their lives. They have a strong sense of national pride; they also think that children should be taught to obey and that the first duty of a child is to make his or her parents proud. They say abortion, euthanasia, divorce, and suicide are never justified. At the other end of this spectrum are secular rational values.

Another category in the World Values Survey is quality of life attributes. At one end of this spectrum are "survival values," the values people hold when the struggle for survival is of paramount importance. These values tend to stress that economic and physical security are more important than self-expression. People who cannot take food

or safety for granted tend to be xenophobic, are wary of political activity, have authoritarian tendencies, and believe that men make better political leaders than women. "Self-expression" or "well-being" values stress the importance of diversity, belonging, and participation in political processes.

As countries get richer, there seems to be a shift from "traditional" to "secular rational" values, and from "survival values" to "well-being" values. The shift, however, takes time, primarily because individuals are socialized into a set of values when they are young and find it difficult to change as they grow older. Substantial changes in values are linked to generations, with younger people typically being in the vanguard of a significant change in values.

With regard to globalization, some have argued that advances in transportation and communication technologies, the dramatic increase in trade that we have witnessed since World War II, and the rise of global corporations such as Hitachi, Disney, Microsoft, and Levi Strauss, whose products and operations can be found around the globe, are helping to create conditions for the merging or convergence of cultures.[64] With McDonald's hamburgers in China, The Gap in India, iPods in South Africa, and MTV everywhere helping to foster a ubiquitous youth culture, and with countries around the world climbing the ladder of economic progress, some argue that the conditions for less cultural variation have been created. There may be, in other words, a slow but steady convergence occurring across different cultures towards some universally accepted values and norms: This is know as the *convergence* hypothesis.[65]

Having said this, one must not ignore important countertrends, such as the shift toward Islamic fundamentalism in several countries; the separatist movement in Quebec, Canada; or the continuing ethnic strains and separatist movements in Russia. Such countertrends in many ways are a reaction to the pressures for cultural convergence. In an increasingly modern and materialistic world, some societies are trying to reemphasize their cultural roots and uniqueness. Cultural change is not unidirectional, with national cultures converging toward some homogenous global entity. It is also important to note that while some elements of culture change quite rapidly—particularly the use of material symbols—other elements change slowly if at all. Thus, just because people the world over wear blue jeans, eat at McDonald's, use cell phones, watch their national version of *American Idol*, and drive Ford cars to work down freeways, one should not assume that they have also adopted American (or Western) values —for often they have not.[66] To illustrate, consider that many Westerners eat Chinese food, watch Chinese martial arts movies, and take classes in kung fu, but their values are still those of Westerners. Thus, a distinction needs to be made between the visible material aspects of culture and the deep structure, particularly core social values and norms. The deep structure changes only slowly, and differences here are often far more persistent than one might suppose.

IMPLICATIONS FOR MANAGERS



International business is different from national business because countries and societies are different. In this chapter, we have seen just how different societies can be. Societies differ because their cultures vary. Their cultures vary because of profound differences in social structure, religion, language, education, economic philosophy, and political philosophy. Three important implications for international business flow from these differences. The first is the need to develop cross-cultural literacy. There is a need not only to appreciate that cultural differences exist but also to appreciate what such differences mean for international business. A second implication centers on the connection between culture and national competitive advantage. A third implication looks at the connection between culture

and ethics in decision making. In this section, we will explore the first two of these issues in depth. The connection between culture and ethics is explored in the next chapter.

CROSS-CULTURAL LITERACY

One of the biggest dangers confronting a company that goes abroad for the first time is the danger of being ill-informed. International businesses that are ill-informed about the practices of another culture are likely to fail. Doing business in different cultures requires adaptation to conform with the value systems and norms of that culture. Adaptation can embrace all aspects of an international firm's operations in a foreign country. The way in which deals are negotiated, the appropriate incentive pay systems for salespeople, the structure of the organization, the name of a product, the tenor of relations between management and labor, the manner in which the product is promoted, and so on, are all sensitive to cultural differences. What works in one culture might not work in another.

To combat the danger of being ill-informed, international businesses should consider employing local citizens to help them do business in a particular culture. They must also ensure that home-country executives are cosmopolitan enough to understand how differences in culture affect the practice of business. Transferring executives overseas at regular intervals to expose them to different cultures will help build a cadre of cosmopolitan executives. An international business must also be constantly on guard against the dangers of *ethnocentric behavior*. **Ethnocentrism** is a belief in the superiority of one's own ethnic group or culture. Hand in hand with ethnocentrism goes a disregard or contempt for the culture of other countries. Unfortunately, ethnocentrism is all too prevalent; many Americans are guilty of it, as are many French people, Japanese people, British people, and so on. Ugly as it is, ethnocentrism is a fact of life, one that international businesses must be on guard against.

Simple examples illustrate how important cross-cultural literacy can be. Anthropologist Edward T. Hall has described how Americans, who tend to be informal in nature, react strongly to being corrected or reprimanded in public.[67] This can cause problems in Germany, where a cultural tendency toward correcting strangers can shock and offend most Americans. For their part, Germans can be a bit taken aback by the tendency of Americans to call everyone by their first name. This is uncomfortable enough among executives of the same rank, but it can be seen as insulting when a young and junior American executive addresses an older and more senior German manager by his first name without having been invited to do so. Hall concludes it can take a long time to get on a first-name basis with a German; if you rush the process you will be perceived as overfriendly and rude, and that may not be good for business.

Hall also notes that cultural differences in attitude to time can cause a myriad of problems. He notes that in the United States, giving a person a deadline is a way of increasing the urgency or relative importance of a task. However, in the Middle East, giving a deadline can have exactly the opposite effect. The American who insists an Arab business associate make his mind up in a hurry is likely to be perceived as overly demanding and exerting undue pressure. The result may be exactly the opposite of what the American intended, with the Arab going slow as a reaction to the American's arrogance and rudeness. For his part, the American may believe that an Arab associate is being rude if he shows up late to a meeting because he met a friend in the street and stopped to talk. The American, of course, is very concerned about time and scheduling. But for the Arab, who lives in a society where social networks are a major source of information, and maintaining relationships is important, finishing the discussion with a friend is more important than adhering to a strict schedule. Indeed, the Arab may be puzzled as to why the American attaches so much importance to time and schedule.

CULTURE AND COMPETITIVE ADVANTAGE

One theme that surfaces in this chapter is the relationship between culture and national competitive advantage. Put simply, the value systems and norms of a country influence the costs of doing business in that country. The costs of doing business in a country influence

the ability of firms to establish a competitive advantage in the global marketplace. We have seen how attitudes toward cooperation between management and labor, toward work, and toward the payment of interest are influenced by social structure and religion. It can be argued that the class-based conflict between workers and management in class-conscious societies, when it leads to industrial disruption, raises the costs of doing business in that society. Similarly, we have seen how some sociologists have argued that the ascetic "otherworldly" ethics of Hinduism may not be as supportive of capitalism as the ethics embedded in Protestantism and Confucianism. Also, Islamic laws banning interest payments may raise the costs of doing business by constraining a country's banking system.

Japan presents an interesting case study of how culture can influence competitive advantage. Some scholars have argued that the culture of modern Japan lowers the costs of doing business relative to the costs in most Western nations. Japan's emphasis on group affiliation, loyalty, reciprocal obligations, honesty, and education all boost the competitiveness of Japanese companies. The emphasis on group affiliation and loyalty encourages individuals to identify strongly with the companies in which they work. This tends to foster an ethic of hard work and cooperation between management and labor "for the good of the company." Similarly, reciprocal obligations and honesty help foster an atmosphere of trust between companies and their suppliers. This encourages them to enter into long-term relationships with each other to work on inventory reduction, quality control, and design—all of which have been shown to improve an organization's competitiveness. This level of cooperation has often been lacking in the West, where the relationship between a company and its suppliers tends to be a short-term one structured around competitive bidding rather than one based on long-term mutual commitments. In addition, the availability of a pool of highly skilled labor, particularly engineers, has helped Japanese enterprises develop cost-reducing process innovations that have boosted their productivity.[68] Thus, cultural factors may help explain the success enjoyed by many Japanese businesses in the global marketplace. Most notably, it has been argued that the rise of Japan as an economic power during the second half of the twentieth century may be in part attributed to the economic consequences of its culture.[69]

It also has been argued that the Japanese culture is less supportive of entrepreneurial activity than, say, American society. In many ways, entrepreneurial activity is a product of an individualistic mind-set, not a classic characteristic of the Japanese. This may explain why American enterprises, rather than Japanese corporations, dominate industries where entrepreneurship and innovation are highly valued, such as computer software and biotechnology. Of course, obvious and significant exceptions to this generalization exist. Masayoshi Son recognized the potential of software far faster than any of Japan's corporate giants; set up his company, Softbank, in 1981; and over the past 30 years has built it into Japan's top software distributor. Similarly, dynamic entrepreneurial individuals established major Japanese companies such as Sony and Matsushita. But these examples may be the exceptions that prove the rule, for as yet there has been no surge in entrepreneurial high-technology enterprises in Japan equivalent to what has occurred in the United States.

For the international business, the connection between culture and competitive advantage is important for two reasons. First, the connection suggests which countries are likely to produce the most viable competitors. For example, one might argue that U.S. enterprises are likely to see continued growth in aggressive, cost-efficient competitors from those Pacific Rim nations where a combination of free market economics, Confucian ideology, group-oriented social structures, and advanced education systems can all be found (e.g., South Korea, Taiwan, Japan, and, increasingly, China).

Second, the connection between culture and competitive advantage has important implications for the choice of countries in which to locate production facilities and do business. Consider a hypothetical case when a company has to choose between two countries, A and B, for locating a production facility. Both countries are characterized by low labor costs and good access to world markets. Both countries are of roughly the same size (in terms of population) and both are at a similar stage of economic development. In country A, the education system is undeveloped, the society is characterized by

a marked stratification between the upper and lower classes, and there are six major linguistic groups. In country B, the education system is well developed, social stratification is lacking, group identification is valued by the culture, and there is only one linguistic group. Which country makes the best investment site?

Country B probably does. In country A, conflict between management and labor, and between different language groups, can be expected to lead to social and industrial disruption, thereby raising the costs of doing business.[70] The lack of a good education system also can be expected to work against the attainment of business goals.

The same kind of comparison could be made for an international business trying to decide where to push its products, country A or B. Again, country B would be the logical choice because cultural factors suggest that in the long run, country B is the nation most likely to achieve the greatest level of economic growth.

But as important as culture is, it is probably less important than economic, political, and legal systems in explaining differential economic growth between nations. Cultural differences are significant, but we should not overemphasize their importance in the economic sphere. For example, earlier we noted that Max Weber argued that the ascetic principles embedded in Hinduism do not encourage entrepreneurial activity. While this is an interesting academic thesis, recent years have seen an increase in entrepreneurial activity in India, particularly in the information technology sector, where India is rapidly becoming an important global player. The ascetic principles of Hinduism and caste-based social stratification have apparently not held back entrepreneurial activity in this sector.

CHAPTER SUMMARY

This chapter looked at the nature of social culture and studied some implications for business practice. The chapter made the following points:

1. Culture is a complex whole that includes knowledge, beliefs, art, morals, law, customs, and other capabilities acquired by people as members of society.
2. Values and norms are the central components of a culture. Values are abstract ideals about what a society believes to be good, right, and desirable. Norms are social rules and guidelines that prescribe appropriate behavior in particular situations.
3. Values and norms are influenced by political and economic philosophy, social structure, religion, language, and education.
4. The social structure of a society refers to its basic social organization. Two main dimensions along which social structures differ are the individual–group dimension and the stratification dimension.
5. In some societies, the individual is the basic building block of social organization. These societies emphasize individual achievements above all else. In other societies, the group is the basic building block of social organization. These societies emphasize group membership and group achievements above all else.
6. All societies are stratified into different classes. Class-conscious societies are characterized by low social mobility and a high degree of stratification. Less class-conscious societies are characterized by high social mobility and a low degree of stratification.
7. Religion may be defined as a system of shared beliefs and rituals that is concerned with the realm of the sacred. Ethical systems refer to a set of moral principles, or values, that are used to guide and shape behavior. The world's major religions are Christianity, Islam, Hinduism, and Buddhism. Although not a religion, Confucianism has an impact on behavior that is as profound as that of many religions. The value systems of different religious and ethical systems have different implications for business practice.
8. Language is one defining characteristic of a culture. It has both spoken and unspoken dimensions. In countries with more than one spoken language, we tend to find more than one culture.
9. Formal education is the medium through which individuals learn skills and are socialized into the values and norms of a society. Education plays an important role in the determination of national competitive advantage.

10. Geert Hofstede studied how culture relates to values in the workplace. He isolated four dimensions that he claimed summarized different cultures: power distance, uncertainty avoidance, individualism versus collectivism, and masculinity versus femininity.
11. Culture is not a constant; it evolves. Economic progress and globalization seem to be two important engines of cultural change.
12. One danger confronting a company that goes abroad for the first time is being ill-informed. To develop cross-cultural literacy, international businesses need to employ host-country nationals, build a cadre of cosmopolitan executives, and guard against the dangers of ethnocentric behavior.
13. The value systems and norms of a country can affect the costs of doing business in that country.

Critical Thinking and Discussion Questions

1. Outline why the culture of a country might influence the costs of doing business in that country. Illustrate your answer with examples.
2. Do you think that business practices in an Islamic country are likely to differ from business practices in the United States? If so, how?
3. What are the implications for international business of differences in the dominant religion or ethical system of a country?
4. Choose two countries that appear to be culturally diverse. Compare the cultures of those countries and then indicate how cultural differences influence (*a*) the costs of doing business in each country, (*b*) the likely future economic development of that country, and (*c*) business practices.
5. Reread the Country Focus about Islamic capitalism in Turkey. Then answer the following questions:
   a. Can you see anything in the value of Islam that is hostile to business?
   b. What does the experience of the region around Kayseri teach about the relationship between Islam and business?
   c. What are the implications of Islamic values toward business for the participation of a country such as Turkey in the global economy?
6. Reread the Management Focus on DMG-Shanghai and answer the follow questions:
   a. Why do you think it is so important to cultivate *guanxi* and *guanxiwang* in China?
   b. What does the experience of DMG tells us about the way things work in China? What would likely happen to a business that obeyed all of the rules and regulations, rather than trying to find a way around them as Dan Mintz apparently does?
   c. What ethical issues might arise when drawing upon *guanxiwang* to get things done in China? What does this suggest about the limits of using *guanxiwang* for a Western business committed to high ethical standards?

Research Task globalEDGE globaledge.msu.edu

Differences in Culture

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

You are preparing for a business trip to Chile where you will need to interact extensively with local professionals. Therefore, you should consider collecting information regarding local culture and business habits prior to your departure. A colleague from Latin America recommends you visit the "*Centre for Intercultural Learning*" and read through the country insights provided for Chile. Prepare a short description of the most striking cultural characteristics that may affect business interactions in this country.

Exercise 2

Typically, cultural factors drive the differences in business etiquette encountered during international business travel. In fact, Middle Eastern cultures exhibit significant differences in business etiquette when compared to Western cultures. Prior to leaving for your first business trip to the region, a colleague informed you that a guide to *business etiquette around the world* may help you. Using the globalEDGE website, find five tips regarding business etiquette in the Middle Eastern country of your choice.

CLOSING CASE

Matsushita (Panasonic) and Japan's Changing Culture

Established in 1920, the consumer electronics giant Matsushita was at the forefront of the rise of Japan to the status of major economic power during the 1970s and 1980s. Like many other long-standing Japanese businesses, Matsushita was regarded as a bastion of traditional Japanese values based on strong group identification, reciprocal obligations, and loyalty to the company. Several commentators attributed Matsushita's success, and that of the Japanese economy, to the existence of Confucian values in the workplace. At Matsushita, employees were taken care of by the company from "cradle to the grave." Matsushita provided them with a wide range of benefits including cheap housing, guaranteed lifetime employment, seniority-based pay systems, and generous retirement bonuses. In return, Matsushita expected, and got, loyalty and hard work from its employees. To Japan's postwar generation, struggling to recover from the humiliation of defeat, it seemed like a fair bargain. The employees worked hard for the greater good of Matsushita, and Matsushita reciprocated by bestowing "blessings" on employees.

However, culture does not stay constant. According to some observers, the generation born after 1964 lacked the same commitment to traditional Japanese values as their parents. They grew up in a world that was richer, where Western ideas were beginning to make themselves felt, and where the possibilities seemed greater. They did not want to be tied to a company for life, to be a "salaryman." These trends came to the fore in the 1990s, when the Japanese economy entered a prolonged economic slump. As the decade progressed, one Japanese firm after another was forced to change its traditional ways of doing business. Slowly at first, troubled companies started to lay off older workers, effectively abandoning lifetime employment guarantees. As younger people saw this happening, they concluded that loyalty to a company might not be reciprocated, effectively undermining one of the central bargains made in postwar Japan.

Matsushita was one of the last companies to turn its back on Japanese traditions, but in 1998, after years of poor performance, it began to modify traditional practices. The principal agents of change were a group of managers who had extensive experience in Matsushita's overseas operations, and included Kunio Nakamura, who became the chief executive of Matsushita in 2000. Nakamura has said the time he spent as a manager of Matsushita subsidiaries in the United States had a strong impact on him, particularly observing how American managers such as Lou Gestner (who turned around IBM) moved quickly to restructure troubled companies.

Under Nakamura, Matsushita changed the pay scheme for its 11,000 managers. In the past, the traditional twice-a-year bonuses had been based almost entirely on seniority, but now Matsushita said they would be based on performance. Matsushita announced this process would be made transparent; managers would be shown what their performance rankings were and how these fed into pay bonuses. As elementary as this might sound in the West, for Matsushita it represented the beginning of a revolution in human resource practices.

Nakamura took aim at the lifetime employment system and the associated perks. Under the new system, recruits were given the choice of three employment options. First, they could sign on to the traditional option. Under this, they were eligible to live in subsidized company housing, go free to company-organized social events, and buy subsidized services such as banking from group companies. They also still would receive a retirement bonus equal to two years' salary. Under a second scheme, employees could forgo the guaranteed retirement bonus in exchange for higher starting salaries and keep perks such as cheap company housing. Under a third scheme, they would lose both the retirement bonus and the subsidized services, but they would start at a still higher salary. In its first two years of operation, only 3 percent of recruits chose the third option— suggesting there is still a hankering for the traditional paternalistic relationship—but 41 percent took the second option.

In other ways Matsushita's designs are grander still. As the company has moved into new industries such as software engineering and network communications technology, it has begun to sing the praises of democratization of employees, and it has sought to encourage individuality, initiative taking, and risk seeking among its younger employees. Nakamura stated he wanted younger managers to become "rational and logical in their thinking . . . to be aggressive and ambitious, and at the same time to create an organization that can carry out their ambitious plans."

But while such changes may be easy to articulate, they are hard to implement. For all of its talk, Matsushita was slow to dismantle its lifetime employment commitment to those hired under the traditional system. This was underlined early in Nakamura's tenure when in response to continued poor performance, Matsushita announced it would close 30 factories in Japan, cut 13,000

jobs including 1,000 management jobs, and sell a "huge amount of assets" over the next three years. While this seemed to indicate a final break with the lifetime employment system—it represented the first layoffs in the company's history—the company also said unneeded management staff would not be fired but instead transferred to higher growth areas such as health care.

With so many of its managers a product of the old way of doing things, a skeptic might question the ability of the company to turn its intentions into a reality. As growth slowed, Matsushita has had to cut back on its hiring, but its continued commitment to longstanding employees means that the average age of its workforce is rising. In the 1960s it was around 25; by the early 2000s it was 35, a trend that might counteract Matsushita's attempts to revolutionize the workplace, for surely those who benefited from the old system will not give way easily to the new. Still, by the mid-2000s it was clear that Matsushita was making progress. After significant losses in 2002, the company broke even in 2003 and started to make profits again in 2004. New growth drivers, such as sales of DVD equipment and flat screen TVs, certainly helped, but so did the cultural and organizational changes that enabled the company to better exploit these new growth opportunities.[71]

Case Discussion Questions

1. What were the triggers of cultural change in Japan during the 1990s? How is cultural change starting to affect traditional values in Japan?
2. How might Japan's changing culture influence the way Japanese businesses operate in the future? What are the potential implications of such changes for the Japanese economy?
3. How did traditional Japanese culture benefit Matsushita during the 1950s–1980s? Did traditional values become more of a liability during the 1990s and early 2000s? How so?
4. What is Matsushita trying to achieve with human resource changes it has announced? What are the impediments to successfully implementing these changes? What are the implications for Matsushita if (*a*) the changes are made quickly or (*b*) it takes years or even decades to fully implement the changes?
5. What does the Matsushita case teach you about the relationship between societal culture and business success?

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5 Ethics in International Business

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Understand the ethical issues faces by international businesses.
- **LO2** Recognize an ethical dilemma.
- **LO3** Identify the causes of unethical behavior by managers.
- **LO4** Describe the different philosophical approaches to ethics.
- **LO5** Explain how managers can incorporate ethical considerations into their decision making.

Working Conditions in a Chinese Factory

In 2008 the National Labor Committee sponsored an investigation into working conditions in two factories in China that make computer equipment, including keyboards and printer cases, for Hewlett-Packard, Dell, Lenovo, and Microsoft. The report, which was published in early 2009, describes working conditions that are extremely harsh by Western standards.

According to the report, in the Metai factory in Guangdong, the workers sit on wooden stools, without backrests, as 500 computer keyboards an hour move down the assembly line, 12 hours a day, seven days a week, with just two days off a month. Every 7.2 seconds a keyboard passes each worker, who has to snap six or seven keys into place—one key every 1.1 seconds. The assembly line never stops. The workplace is frantic, monotonous, numbing, and relentless. Each worker inserts 3,250 keys an hour; 35,750 keys during the official 11-hour shift; 250,250 a week, performing over 1 million operations a month. Workers are paid 1/50th of a cent for each operation they complete. While working, employees cannot talk, listen to music, or even lift their heads to look around. Workers needing to use the bathroom must hold it until there is a break. Security guards spy on the workers, who are prohibited from putting their hands in their pockets and are searched when they enter and leave the factory. The factory operates 24 hours a day on two 12-hour shifts, with the workers rotating between day and night shifts each month. The workers are at the factory for up to 87 hours a week, and all overtime is mandatory. There are two half-hour meal breaks per shift, but after racing to the cafeteria and lining up to get food, the workers have only about 15 minutes to eat. The base wage is 64 cents an hour, which after deductions for primitive room and board drops to a take-home wage of just 41 cents an hour. The workers get up about 6:00 a.m. When they return to their dorm, sometime between 9:00 and 9:30 p.m., they bathe using a small plastic bucket. Summer



temperatures routinely reach into the high 90s. During the winter, workers have to walk down several flights of stairs to fetch hot water in their buckets. Ten to twelve workers share each crowded dorm room, sleeping on narrow metal bunk beds that line the walls. Workers drape old sheets over their cubicle openings for privacy.

Comments from the workers at this factory, most of whom are young women between 18 and their mid-20s, reinforce how harsh the conditions are. One stated, "Every day I enter the factory and I assemble keyboards. My hands are moving constantly and I can't stop for a second. Our fingers, hands and arms are swollen and sore. Every day I do this for 12 hours. What makes it even worse is the constant pressure and boring monotony of the work." Another notes, "The factory rules are really like a private law. We are forced to obey and endure management's harsh treatment. Some young workers have boyfriends and girlfriends outside the factory and if they want to go on a date, we have to beg the boss for mercy to be able to leave the factory compound." Another said simply, "We feel like we are serving prison sentences."

When informed of these findings, a spokesman for Microsoft said the factory supplied one if its contract manufacturers, but Microsoft would investigate. Representatives from Hewlett-Packard and Lenovo also stated the factory was not a direct supplier, but supplied their suppliers. However, they too said they would look into the issue. A spokesman for Dell, for whom the factory is a direct supplier, said it was actively investigating conditions. The spokesman went on to say, "I can tell you that any reports of poor working conditions in Dell's supply chain are investigated and appropriate action is taken." As of early 2011, no reports could be found indicating whether any of these companies had indeed investigated the situation and decided upon a course of action.[1]

Introduction

The opening case describes awful working conditions at the Metai factory in China; the factory supplies computer keyboards and similar products to companies such as Microsoft, Dell, Hewlett-Packard, and Lenovo. No doubt work was contracted out to this factory because the costs are low. However, the description of working conditions raises the question of whether it is ethical to outsource production to such a factory, and what, if anything, companies that rely upon it as a supplier should do about this issue. The situation at the Metai factory presents companies that use it as a supplier with an ethical problem. Understanding the nature of ethical problems, and deciding what action to pursue when confronted with one, is a central theme in this chapter. Ethical problems occur frequently in international business.

The term *ethics* refers to accepted principles of right or wrong that govern the conduct of a person, the members of a profession, or the actions of an organization. **Business ethics** are the accepted principles of right or wrong governing the conduct of businesspeople, and an **ethical strategy** is a strategy, or course of action, that does not violate these accepted principles. This chapter looks at how ethical issues should be incorporated into decision making in an international business. The chapter also reviews the reasons for poor ethical decision making and discusses different philosophical approaches to business ethics. The chapter closes by reviewing the different processes that managers can adopt to make sure that ethical considerations are incorporated into decision making in an international business.

LO1 Ethical Issues in International Business

Many of the ethical issues in international business are rooted in the fact that political systems, law, economic development, and culture vary significantly from nation to nation. What is considered normal practice in one nation may be considered unethical in another. Because they work for an institution that transcends national borders and cultures, managers in a multinational firm need to be particularly sensitive to these differences. In the international business setting, the most common ethical issues involve employment practices, human rights, environmental regulations, corruption, and the moral obligation of multinational corporations.

EMPLOYMENT PRACTICES

When work conditions in a host nation are clearly inferior to those in a multinational's home nation, what standards should be applied? Those of the home nation, those of the host nation, or something in between? While few would suggest that pay and work conditions should be the same across nations, how much divergence is acceptable? For example, while 12-hour workdays, extremely low pay, and a failure to protect workers against toxic chemicals may be common in some developing nations, does this mean that it is OK for a multinational to tolerate such working conditions in its subsidiaries there, or to condone it by using local subcontractors (the opening case gives an example of such a situation).

In the 1990s Nike found itself the center of a storm of protests when news reports revealed that working conditions at many of its subcontractors were very poor. Typical of the allegations were those detailed in a *48 Hours* program that aired in 1996. The report painted a picture of young women who worked with toxic materials six days a week in poor conditions for only 20 cents an hour at a Vietnamese subcontractor. The report also stated that a living wage in Vietnam was at least $3 a day, an income that could not be achieved at the subcontractor without working substantial overtime. Nike and its subcontractors were not breaking any laws, but this report, and others like it, raised questions about the ethics of using sweatshop labor to make what were essentially fashion

accessories. It may have been legal, but was it ethical to use subcontractors who by Western standards clearly exploited their workforce? Nike's critics thought not, and the company found itself the focus of a wave of demonstrations and consumer boycotts. These exposés surrounding Nike's use of subcontractors forced the company to reexamine its policies. Realizing that, even though it was breaking no law, its subcontracting policies were perceived as unethical, Nike's management established a code of conduct for Nike subcontractors and instituted annual monitoring by independent auditors of all subcontractors.[2]

As the Nike case demonstrates, a strong argument can be made that it is not OK for a multinational firm to tolerate poor working conditions in its foreign operations or those of subcontractors. However, this still leaves unanswered the question of what standards should be applied. We shall return to and consider this issue in more detail later in the chapter. For now, note that establishing minimal acceptable standards that safeguard the basic rights and dignity of employees, auditing foreign subsidiaries and subcontractors on a regular basis to make sure those standards are met, and taking corrective action if they are not is a good way to guard against ethical abuses. Another Western company, Levi Strauss, has long taken such an approach. The company terminated a long-term contract with one of its large suppliers, the Tan family, after it discovered the Tans were allegedly forcing 1,200 Chinese and Filipino women to work 74 hours per week in guarded compounds on the Mariana Islands.[3] For another example of problems with working practices among suppliers, read the accompanying Management Focus, which looks at working conditions in a factory that supplied Apple with iPods.

HUMAN RIGHTS

Questions of human rights can arise in international business. Basic human rights still are not respected in many nations. Rights taken for granted in developed nations, such as freedom of association, freedom of speech, freedom of assembly, freedom of movement, freedom from political repression, and so on, are by no means universally accepted (see Chapter 2 for details). One of the most obvious historic examples was South Africa during the days of white rule and apartheid, which did not end until 1994. The apartheid system denied basic political rights to the majority nonwhite population of South Africa, mandated segregation between whites and nonwhites, reserved certain occupations exclusively for whites, and prohibited blacks from being placed in positions where they would manage whites. Despite the odious nature of this system, Western businesses operated in South Africa. By the 1980s, however, many questioned the ethics of doing so. They argued that inward investment by foreign multinationals, by boosting the South African economy, supported the repressive apartheid regime.

Several Western businesses started to change their policies in the late 1970s and early 1980s.[4] General Motors, which had significant activities in South Africa, was at the forefront of this trend. GM adopted what came to be called the *Sullivan principles*, named after Leon Sullivan, a black Baptist minister and a member of GM's board of directors. Sullivan argued that it was ethically justified for GM to operate in South Africa so long as two conditions were fulfilled. First, the company should not obey the apartheid laws in its own South African operations (a form of passive resistance). Second, the company should do everything within its power to promote the abolition of apartheid laws. Sullivan's principles were widely adopted by U.S. firms operating in South Africa. Their violation of the apartheid laws was ignored by the South African government, which clearly did not want to antagonize important foreign investors.

However, after 10 years, Leon Sullivan concluded that simply following the principles was not sufficient to break down the apartheid regime and that any American company, even those adhering to his principles, could not ethically justify their continued presence in South Africa. Over the next few years, numerous companies divested their South African operations, including Exxon, General Motors, Kodak, IBM, and Xerox. At the same time, many state pension funds signaled they would no longer hold stock in



MANAGEMENT FOCUS

Making Apple's iPod

In mid-2006 news reports surfaced suggesting there were systematic labor abuses at a factory in China that makes the iconic iPod for Apple Computer. According to the reports, workers at Hongfujin Precision Industries were paid as little as $50 a month to work 15-hour shifts making the iPod. There were also reports of forced overtime and poor living conditions for the workers, many of them young women who had migrated from the countryside to work at the plant and lived in company-owned dormitories. The articles were the work of two Chinese journalists, Wang You and Weng Bao, employed by *China Business News*, a state-run newspaper. The target of the reports, Hongfujin Precision Industries, was reportedly China's largest export manufacturer in 2005 with overseas sales totaling $14.5 billion. Hongfujin is owned by Foxconn, a large Taiwanese conglomerate, whose customers in addition to Apple include Intel, Dell, and Sony Corporation. The Hongfujin factory is a small city in its own right, with clinics, recreational facilities, buses, and 13 restaurants that serve the 200,000 employees.

Upon hearing the news, Apple management responded quickly, pledging to audit the operations to make sure Hongfujin was complying with Apple's code on labor standards for subcontractors. Managers at Hongfujin took a somewhat different tack; they filed a defamation suit against the two journalists, suing them for $3.8 million in a local court, which promptly froze the journalists' personal assets pending a trial. Clearly, the management of Hongfujin was trying to send a message to the journalist community—criticism would be costly. The suit sent a chill through the Chinese journalist community because Chinese courts have shown a tendency to favor powerful locally based companies in legal proceedings.

Within six weeks, Apple had completed its audit. The company's report suggested that although workers had not been forced to work overtime and were earning at least the local minimum wage, many had worked more than the 60 hours a week allowed for by Apple, and their housing was substandard. Under pressure from Apple, management at Hongfujin agreed to bring practices in line with Apple's code, committing to building new housing for employees and limiting work to 60 hours a week.

However, Hongfujin did not immediately withdraw the defamation suite. In an unusually bold move in a country where censorship is still common, *China Business News* gave its unconditional backing to Wang and Weng. The Shanghai-based news organization issued a statement arguing that what the two journalists did "was not a violation of any rules, laws, or journalistic ethics." The Paris-based Reporters Without Borders also took up the case of Wang and Weng, writing a letter to Apple's CEO Steve Jobs stating, "We believe that all Wang and Weng did was to report the facts and we condemn Foxconn's reaction. We therefore ask you to intercede on behalf of these two journalists so that their assets are unfrozen and the lawsuit is dropped."

Once again, Apple moved quickly, pressuring Foxconn behind the scenes to drop the suit. In early September, Foxconn agreed to do so and issued a "face-saving" statement saying the two sides had agreed to end the dispute after apologizing to each other "for the disturbances bought to both of them by the lawsuit." While the dispute is now over, the experience shed a harsh light on labor conditions in China. At the same time, the response of the Chinese media, and *China Business News* in particular, point toward the emergence of some journalistic freedoms in a nation that has historically seen news organizations as a mouthpiece for the state.[5]

companies that did business in South Africa, which helped to persuade several companies to divest their South African operations. These divestments, coupled with the imposition of economic sanctions from the United States and other governments, contributed to the abandonment of white minority rule and apartheid in South Africa and the introduction of democratic elections in 1994. Thus, adopting an ethical stance was argued to have helped improve human rights in South Africa.[6]

Although change has come in South Africa, many repressive regimes still exist in the world. Is it ethical for multinationals to do business in them? It is often argued that inward

investment by a multinational can be a force for economic, political, and social progress that ultimately improves the rights of people in repressive regimes. This position was first discussed in Chapter 2, when we noted that economic progress in a nation could create pressure for democratization. In general, this belief suggests it is ethical for a multinational to do business in nations that lack the democratic structures and human rights records of developed nations. Investment in China, for example, is frequently justified on the grounds that although China's human rights record is often questioned by human rights groups, and although the country is not a democracy, continuing inward investment will help boost economic growth and raise living standards. These developments will ultimately create pressures from the Chinese people for more participative government, political pluralism, and freedom of expression and speech.



Nigerian women and children protest Royal Dutch Shell in April 2004.

However, there is a limit to this argument. As in the case of South Africa, some regimes are so repressive that investment cannot be justified on ethical grounds. Another example would be Myanmar (formally known as Burma). Ruled by a military dictatorship for more than 45 years, Myanmar has one of the worst human rights records in the world. Beginning in the mid-1990s, many Western companies exited Myanmar, judging the human rights violations to be so extreme that doing business there cannot be justified on ethical grounds. (In contrast, the accompanying Management Focus looks at the controversy surrounding one company, Unocal, which chose to stay in Myanmar.) However, a cynic might note that Myanmar has a small economy and that divestment carries no great economic penalty for Western firms, unlike, for example, divestment from China.

Nigeria is another country where serious questions have arisen over the extent to which foreign multinationals doing business in the country have contributed to human rights violations. Most notably, the largest foreign oil producer in the country, Royal Dutch Shell, has been repeatedly criticized.[7] In the 1990s, several ethnic groups in Nigeria, which was ruled by a military dictatorship, protested against foreign oil companies for causing widespread pollution and failing to invest in the communities from which they extracted oil. Shell reportedly requested the assistance of Nigeria's Mobile Police Force (MPF) to quell the demonstrations. According to the human rights group Amnesty International, the results were bloody. In one case, the MPF put down protests against Shell in the village of Umuechem, killing 80 people and destroying 495 homes. Following protests in the Ogoni region of Nigeria that were designed to stop contractors from laying a new pipeline for Shell, the MPF raided the area to quell the unrest. In the chaos that followed, it has been alleged that 27 villages were razed, 80,000 Ogoni people displaced, and 2,000 people killed.

Critics argued that Shell shouldered some of the blame for the massacres. Shell never acknowledged this, and the MPF probably used the demonstrations as a pretext for punishing an ethnic group that had been agitating against the central government for some time. Nevertheless, these events did prompt Shell to look at its own ethics and to set up internal mechanisms to ensure that its subsidiaries acted in a manner that was consistent with basic human rights.[8] More generally, the question remains, what is the responsibility of a foreign multinational when operating in a country where basic human rights are trampled on? Should the company be there at all, and if it is there, what actions should it take to avoid the situation Shell found itself in?

ENVIRONMENTAL POLLUTION

Ethical issues arise when environmental regulations in host nations are inferior to those in the home nation. Many developed nations have substantial regulations governing the



MANAGEMENT FOCUS

Unocal in Myanmar

In 1995, Unocal, an oil and gas enterprise based in California, took a 29 percent stake in a partnership with the French oil company Total and state-owned companies from both Myanmar and Thailand to build a gas pipeline from Myanmar to Thailand. At the time, the $1 billion project was expected to bring Myanmar about $200 million in annual export earnings, a quarter of the country's total. The gas used domestically would increase Myanmar's generating capacity by 30 percent. This investment was made when a number of other American companies were exiting Myanmar. Myanmar's government, a military dictatorship, had a reputation for brutally suppressing internal dissent. Citing the political climate, the apparel companies Levi Strauss and Eddie Bauer had both withdrawn from the country. However, as far as Unocal's management was concerned, the giant infrastructure project would generate healthy returns for the company and, by boosting economic growth, a better life for Myanmar's 43 million people. Moreover, while Levi Strauss and Eddie Bauer could easily shift production of clothes to another low-cost location, Unocal argued it had to go where the oil and gas were located.

However, Unocal's investment quickly became highly controversial. Under the terms of the contract, the government of Myanmar was contractually obliged to clear a corridor for the pipeline through Myanmar's tropical forests and to protect the pipeline from attacks by the government's enemies. According to human rights groups, the Myanmar army forcibly moved villages and ordered hundreds of local peasants to work on the pipeline in conditions that were no better than slave labor. Those who refused suffered retaliation. News reports cite the case of one woman who was thrown into a fire, along with her baby, after her husband tried to escape from troops forcing him to work on the project. The baby died and she suffered burns. Other villagers report being beaten, tortured, raped, and otherwise mistreated when the alleged slave labor conditions were occurring.

In 1996, human rights activists brought a lawsuit against Unocal in the United States on behalf of 15 Myanmar villagers who had fled to refugee camps in Thailand. The suit claimed that Unocal was aware of what was going on, even if it did not participate or condone it, and that awareness was enough to make Unocal in part responsible for the alleged crimes. The presiding judge dismissed the case, arguing that Unocal could not be held liable for the actions of a foreign government against its own people—although the judge did note that Unocal was indeed aware of what was going on in Myanmar. The plaintiffs appealed, and in late 2003 the case wound up at a superior court. In 2005 the case was settled out of court for an undisclosed amount. Unocal itself was acquired by Chevron in 2005.[9]

emission of pollutants, the dumping of toxic chemicals, the use of toxic materials in the workplace, and so on. Those regulations are often lacking in developing nations, and according to critics, the result can be higher levels of pollution from the operations of multinationals than would be allowed at home. For example, consider again the case of foreign oil companies in Nigeria. According to a report prepared by environmental activists in Nigeria, in the Niger Delta region:

> Apart from air pollution from the oil industry's emissions and flares day and night, producing poisonous gases that are silently and systematically wiping out vulnerable airborne biota and endangering the life of plants, game, and man himself, we have widespread water pollution and soil/land pollution that results in the death of most aquatic eggs and juvenile stages of the life of fin fish and shell fish on the one hand, whilst, on the other hand, agricultural land contaminated with oil spills becomes dangerous for farming, even where they continue to produce significant yields.[10]

The implication inherent in this description is that pollution controls applied by foreign companies in Nigeria were much laxer than those in developed nations.

Should a multinational feel free to pollute in a developing nation? (To do so hardly seems ethical.) Is there a danger that amoral management might move production to a

developing nation precisely because costly pollution controls are not required, and the company is therefore free to despoil the environment and perhaps endanger local people in its quest to lower production costs and gain a competitive advantage? What is the right and moral thing to do in such circumstances: pollute to gain an economic advantage, or make sure that foreign subsidiaries adhere to common standards regarding pollution controls?

These questions take on added importance because some parts of the environment are a public good that no one owns, but anyone can despoil. No one owns the atmosphere or the oceans, but polluting both, no matter where the pollution originates, harms all.[11] The atmosphere and oceans can be viewed as a global commons from which everyone benefits but for which no one is specifically responsible. In such cases, a phenomenon known as the *tragedy of the commons* becomes applicable. The tragedy of the commons occurs when a resource held in common by all, but owned by no one, is overused by individuals, resulting in its degradation. The phenomenon was first named by Garrett Hardin when describing a particular problem in sixteenth-century England. Large open areas, called commons, were free for all to use as pasture. The poor put out livestock on these commons and supplemented their meager incomes. It was advantageous for each to put out more and more livestock, but the social consequence was far more livestock than the commons could handle. The result was overgrazing, degradation of the commons, and the loss of this much-needed supplement.[12]

In the modern world, corporations can contribute to the *global tragedy of the commons* by moving production to locations where they are free to pump pollutants into the atmosphere or dump them in oceans or rivers, thereby harming these valuable global commons. While such action may be legal, is it ethical? Again, such actions seem to violate basic societal notions of ethics and social responsibility. This issue is taking on greater importance as concerns about human-induced global warming move to center stage. Most climate scientists argue that human industrial and commercial activity is increasing the amount of carbon dioxide in the atmosphere; carbon dioxide is a greenhouse gas, which reflects heat back to the earth's surface, warming the globe; and as a result, the average temperature of the earth is increasing. The accumulated scientific evidence from numerous databases supports this argument.[13] Consequently, societies around the world are starting to restrict the amount of carbon dioxide that can be emitted into the atmosphere as a by-product of industrial and commercial activity. However, regulations differ from nation to nation. Given this, is it ethical for a company to try to escape tight emission limits by moving production to a country with lax regulations, given that doing so will contribute to global warming? Again, many would argue that doing so violates basic ethical principles.

CORRUPTION

As noted in Chapter 2, corruption has been a problem in almost every society in history, and it continues to be one today.[14] There always have been and always will be corrupt government officials. International businesses can and have gained economic advantages by making payments to those officials. A classic example concerns a well-publicized incident in the 1970s. Carl Kotchian, the president of Lockheed, made a $12.5 million payment to Japanese agents and government officials to secure a large order for Lockheed's TriStar jet from Nippon Air. When the payments were discovered, U.S. officials charged Lockheed with falsification of its records and tax violations. Although such payments were supposed to be an accepted business practice in Japan (they might be viewed as an exceptionally lavish form of gift giving), the revelations created a scandal there too. The government ministers in question were criminally charged, one committed suicide, the government fell in disgrace, and the Japanese people were outraged. Apparently, such a payment was not an accepted way of doing business in Japan! The payment was nothing more than a bribe, paid to corrupt officials, to secure a large order that might otherwise have gone to another manufacturer, such as Boeing. Kotchian clearly engaged in unethical behavior, and to argue that the payment was an "acceptable form of doing business in Japan" was self-serving and incorrect.



MANAGEMENT FOCUS

Corruption at Daimler

In 1998 Daimler, one of the world's largest manufactures of automobiles, purchased the Chrysler Corporation. Soon afterward, a former Chrysler auditor identified suspicious payments being made by subsidiaries. For example, in 2002 Daimler's Chinese subsidiary paid $25,000 to a Texas company listed at a residential apartment complex in Houston. The auditor suspected that such payments were bribes and reported the issue to the Securities and Exchange Commission, which then teamed up with the Department of Justice and began an investigation.

The investigation took eight years. During that time, investigators uncovered a pattern of corruption so widespread that an SEC official described it as "standard operating practice at Daimler." In the case of the $25,000 payment, the Texas company was a shell organization established to launder the money, and the payment was to be passed on to the wife of a Chinese government official who was involved in contract negotiations for about $1.3 million in commercial vehicles. In another case, bribes were given to secure the sale of passenger and commercial vehicles to government entities in Russia. Daimler overcharged for the cars on invoices and passed the overpayments to bank accounts in Latvia controlled by the Russian officials responsible for the purchase decision. In certain cases, Daimler made bribes from "cash desks," allowing employees to take out large amounts of currency to make payments to foreign officials.

In total, the investigation uncovered hundreds of such payments in at least 22 countries that were linked to the sale of vehicles valued at $1.9 billion. The SEC stated, "The bribery was so pervasive in Daimler's decentralized corporate structure that it extended outside of the sales organization to internal audit, legal, and finance departments. These departments should have caught and stopped the illegal sales practices, but instead they were permitted or directly involved in the company's bribery practices."

Threatened with court proceedings in the United States, in 2010 Daimler entered into a consent decree with the SEC under which it agreed to pay $187 million in criminal and civil fines. While subsidiaries of Daimler in Germany and Russia pleaded guilty to corruption charges, the corporate parent and the Chinese subsidiary will avoid indictment so long as they live up to an agreement to halt such practices.[15]

The Lockheed case was the impetus for the 1977 passage of the **Foreign Corrupt Practices Act** in the United States, discussed in Chapter 2. The act outlawed the paying of bribes to foreign government officials to gain business. Some U.S. businesses immediately objected that the act would put U.S. firms at a competitive disadvantage (there is no evidence that subsequently occurred).[16] The act was subsequently amended to allow for "facilitating payments." Sometimes known as speed money or grease payments, facilitating payments are *not* payments to secure contracts that would not otherwise be secured and nor are they payments to obtain exclusive preferential treatment. Rather they are payments to ensure receiving the standard treatment that a business ought to receive from a foreign government, but might not due to the obstruction of a foreign official. The accompanying Management Focus looks at what happened when the German company Daimler ran afoul of the Foreign Corrupt Practices Act.

In 1997, the trade and finance ministers from the member states of the Organization for Economic Cooperation and Development (OECD) followed the U.S. lead and adopted the **Convention on Combating Bribery of Foreign Public Officials in International Business Transactions**.[17] The convention, which went into force in 1999, obliges member states and other signatories to make the bribery of foreign public officials a criminal offense. The convention excludes facilitating payments made to expedite routine government action from the convention.

While facilitating payments, or *speed money*, are excluded from both the Foreign Corrupt Practices Act and the OECD convention on bribery, the ethical implications of making such payments are unclear. In many countries, payoffs to government officials in

the form of speed money are a part of life. One can argue that not investing because government officials demand speed money ignores the fact that such investment can bring substantial benefits to the local populace in terms of income and jobs. From a pragmatic standpoint, giving bribes, although a little evil, might be the price that must be paid to do a greater good (assuming the investment creates jobs where none existed and assuming the practice is not illegal). Several economists advocate this reasoning, suggesting that in the context of pervasive and cumbersome regulations in developing countries, corruption may improve efficiency and help growth! These economists theorize that in a country where preexisting political structures distort or limit the workings of the market mechanism, corruption in the form of black-marketeering, smuggling, and side payments to government bureaucrats to "speed up" approval for business investments may enhance welfare.[18] Arguments such as this persuaded the U.S. Congress to exempt facilitating payments from the Foreign Corrupt Practices Act.

In contrast, other economists have argued that corruption reduces the returns on business investment and leads to low economic growth.[19] In a country where corruption is common, unproductive bureaucrats who demand side payments for granting the enterprise permission to operate may siphon off the profits from a business activity. This reduces businesses' incentive to invest and may retard a country's economic growth rate. One study of the connection between corruption and economic growth in 70 countries found that corruption had a significant negative impact on a country's growth rate.[20] Another study found that firms that paid more in bribes are likely to spend more, not less, management time with bureaucrats negotiating regulations, and that this tended to raise the costs of the firm.[21]

Given the debate and the complexity of this issue, one again might conclude that generalization is difficult and the demand for speed money creates a genuine ethical dilemma. Yes, corruption is bad, and yes, it may harm a country's economic development, but yes, there are also cases where side payments to government officials can remove the bureaucratic barriers to investments that create jobs. However, this pragmatic stance ignores the fact that corruption tends to corrupt both the bribe giver and the bribe taker. Corruption feeds on itself, and once an individual starts down the road of corruption, pulling back may be difficult if not impossible. This argument strengthens the ethical case for never engaging in corruption, no matter how compelling the benefits might seem.

Many multinationals have accepted this argument. The large oil multinational BP, for example, has a zero-tolerance approach toward facilitating payments. Other corporations have a more nuanced approach. For example, consider the following from the code of ethics at Dow Corning:

> Dow Corning employees will not authorize or give payments or gifts to government employees or their beneficiaries or anyone else in order to obtain or retain business. Facilitating payments to expedite the performance of routine services are strongly discouraged. In countries where local business practice dictates such payments and there is no alternative, facilitating payments are to be for the minimum amount necessary and must be accurately documented and recorded.[22]

This statement allows for facilitating payments when "there is no alternative," although they are strongly discouraged.

MORAL OBLIGATIONS

Multinational corporations have power that comes from their control over resources and their ability to move production from country to country. Although that power is constrained not only by laws and regulations, but also by the discipline of the market and the competitive process, it is substantial. Some moral philosophers argue that with power comes the social responsibility for multinationals to give something back to the societies that enable them to prosper and grow. The concept of **social responsibility** refers to the idea that businesspeople should consider the social consequences of economic

actions when making business decisions, and that there should be a presumption in favor of decisions that have both good economic and social consequences.[23] In its purest form, social responsibility can be supported for its own sake simply because it is the right way for a business to behave. Advocates of this approach argue that businesses, particularly large successful businesses, need to recognize their *noblesse oblige* and give something back to the societies that have made their success possible. *Noblesse oblige* is a French term that refers to honorable and benevolent behavior considered the responsibility of people of high (noble) birth. In a business setting, it is taken to mean benevolent behavior that is the responsibility of *successful* enterprises. This has long been recognized by many businesspeople, resulting in a substantial and venerable history of corporate giving to society and in businesses making social investments designed to enhance the welfare of the communities in which they operate.

However, there are examples of multinationals that have abused their power for private gain. The most famous historic example relates to one of the earliest multinationals, the British East India Company. Established in 1600, the East India Company grew to dominate the entire Indian subcontinent in the nineteenth century. At the height of its power, the company deployed over 40 warships, possessed the largest standing army in the world, was the de facto ruler of India's 240 million people, and even hired its own church bishops, extending its dominance into the spiritual realm.[24]

Power itself is morally neutral; how power is used is what matters. It can be used in a positive way to increase social welfare, which is ethical, or it can be used in a manner that is ethically and morally suspect. Some multinationals have acknowledged a moral obligation to use their power to enhance social welfare in the communities where they do business. BP, one of the world's largest oil companies, has made it part of the company policy to undertake "social investments" in the countries where it does business.[25] In Algeria, BP has been investing in a major project to develop gas fields near the desert town of Salah. When the company noticed the lack of clean water in Salah, it built two desalination plants to provide drinking water for the local community and distributed containers to residents so they could take water from the plants to their homes. There was no economic reason for BP to make this social investment, but the company believes it is morally obligated to use its power in constructive ways. The action, while a small thing for BP, is a very important thing for the local community.

LO² Ethical Dilemmas

The ethical obligations of a multinational corporation toward employment conditions, human rights, corruption, environmental pollution, and the use of power are not always clear-cut. There may be no agreement about accepted ethical principles. From an international business perspective, some argue that what is ethical depends upon one's cultural perspective.[26] In the United States, it is considered acceptable to execute murderers but in many cultures this is not acceptable—execution is viewed as an affront to human dignity and the death penalty is outlawed. Many Americans find this attitude very strange, but many Europeans find the American approach barbaric. For a more business-oriented example, consider the practice of "gift giving" between the parties to a business negotiation. While this is considered right and proper behavior in many Asian cultures, some Westerners view the practice as a form of bribery, and therefore unethical, particularly if the gifts are substantial.

Managers often confront very real ethical dilemmas where the appropriate course of action is not clear. For example, imagine that a visiting American executive finds that a foreign subsidiary in a poor nation has hired a 12-year-old girl to work on a factory floor. Appalled to find that the subsidiary is using child labor in direct violation of the company's own ethical code, the American instructs the local manager to replace the child with an adult. The local manager dutifully complies. The girl, an orphan, who is the only breadwinner for herself and her 6-year-old brother, is

unable to find another job, so in desperation she turns to prostitution. Two years later she dies of AIDS. Meanwhile, her brother takes up begging. He encounters the American while begging outside the local McDonald's. Oblivious that this was the man responsible for his fate, the boy begs him for money. The American quickens his pace and walks rapidly past the outstretched hand into the McDonald's, where he orders a quarter-pound cheeseburger with fries and cold milk shake. A year later, the boy contracts tuberculosis and dies.

Had the visiting American understood the gravity of the girl's situation, would he still have requested her replacement? Perhaps not! Would it have been better, therefore, to stick with the status quo and allow the girl to continue working? Probably not, because that would have violated the reasonable prohibition against child labor found in the company's own ethical code. What then would have been the right thing to do? What was the obligation of the executive given this ethical dilemma?

There is no easy answer to these questions. That is the nature of **ethical dilemmas**—they are situations in which none of the available alternatives seems ethically acceptable.[27] In this case, employing child labor was not acceptable, but given that she was employed, neither was denying the child her only source of income. What the American executive needed, what all managers need, was a moral compass, or perhaps an ethical algorithm, that would guide him through such an ethical dilemma to find an acceptable solution. Later we will outline what such a moral compass, or ethical algorithm, might look like. For now, it is enough to note that ethical dilemmas exist because many real-world decisions are complex, difficult to frame, and involve first-, second-, and third-order consequences that are hard to quantify. Doing the right thing, or even knowing what the right thing might be, is often far from easy.[28]

The Roots of Unethical Behavior

LO3

Examples abound of managers behaving in a manner that might be judged unethical in an international business setting. Why do managers behave in an unethical manner? There is no simple answer to this question, for the causes are complex, but some generalizations can be made (see Figure 5.1).[29]

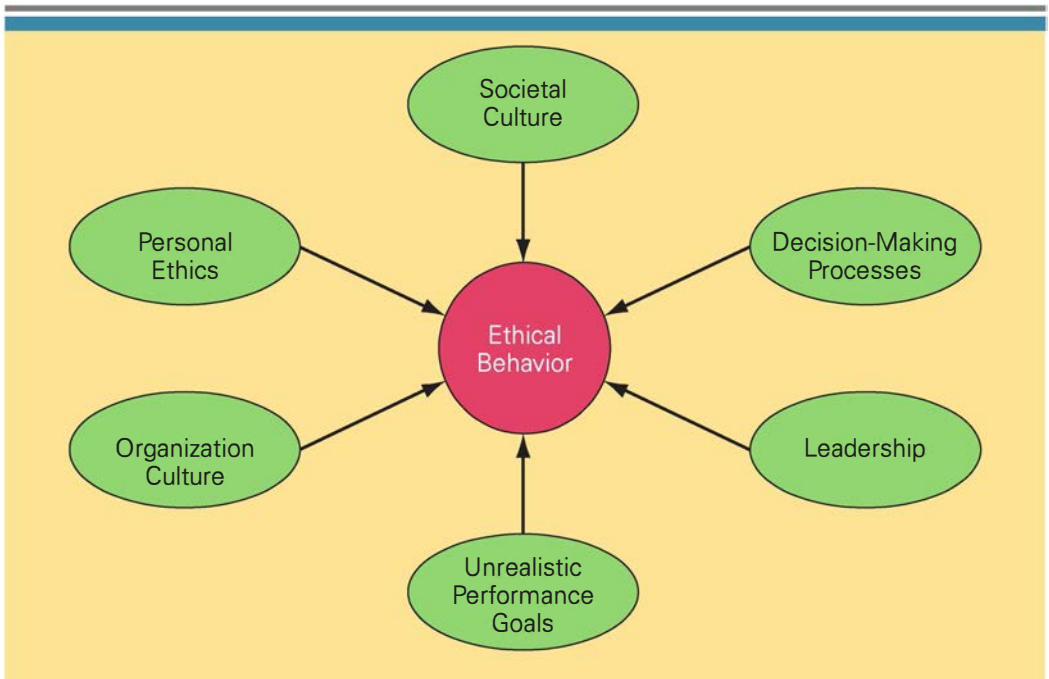

FIGURE 5.1
Determinants of Ethical Behavior

PERSONAL ETHICS

Societal business ethics are not divorced from *personal ethics*, which are the generally accepted principles of right and wrong governing the conduct of individuals. As individuals, we are typically taught that it is wrong to lie and cheat—it is unethical—and that it is right to behave with integrity and honor, and to stand up for what we believe to be right and true. This is generally true across societies. The personal ethical code that guides our behavior comes from a number of sources, including our parents, our schools, our religion, and the media. Our personal ethical code exerts a profound influence on the way we behave as businesspeople. An individual with a strong sense of personal ethics is less likely to behave in an unethical manner in a business setting. It follows that the first step to establishing a strong sense of business ethics is for a society to emphasize strong personal ethics.

Home-country managers working abroad in multinational firms (expatriate managers) may experience more than the usual degree of pressure to violate their personal ethics. They are away from their ordinary social context and supporting culture, and they are psychologically and geographically distant from the parent company. They may be based in a culture that does not place the same value on ethical norms important in the manager's home country, and they may be surrounded by local employees who have less rigorous ethical standards. The parent company may pressure expatriate managers to meet unrealistic goals that can only be fulfilled by cutting corners or acting unethically. For example, to meet centrally mandated performance goals, expatriate managers might give bribes to win contracts or might implement working conditions and environmental controls that are below minimal acceptable standards. Local managers might encourage the expatriate to adopt such behavior. Due to its geographical distance, the parent company may be unable to see how expatriate managers are meeting goals, or may choose not to see how they are doing so, allowing such behavior to flourish and persist.

DECISION-MAKING PROCESSES

Several studies of unethical behavior in a business setting have concluded that businesspeople sometimes do not realize they are behaving unethically, primarily because they simply fail to ask, "Is this decision or action ethical?"[30] Instead, they apply a straightforward business calculus to what they perceive to be a business decision, forgetting that the decision may also have an important ethical dimension. The fault lies in processes that do not incorporate ethical considerations into business decision making. This may have been the case at Nike when managers originally made subcontracting decisions (see the earlier discussion). Those decisions were probably made based on good economic logic. Subcontractors were probably chosen based on business variables such as cost, delivery, and product quality and the key managers simply failed to ask, "How does this subcontractor treat its workforce?" If they thought about the question at all, they probably reasoned that it was the subcontractor's concern, not theirs.

ORGANIZATION CULTURE

The climate in some businesses does not encourage people to think through the ethical consequences of business decisions. This brings us to the third cause of unethical behavior in businesses—an organizational culture that deemphasizes business ethics, reducing all decisions to the purely economic. The term **organization culture** refers to the values and norms that are shared among employees of an organization. You will recall from Chapter 4 that *values* are abstract ideas about what a group believes to be good, right, and desirable, while *norms* are the social rules and guidelines that prescribe appropriate behavior in particular situations. Just as societies have cultures, so do business organizations. Together, values and norms shape the culture of a business organization, and that culture has an important influence on the ethics of business decision making.

The Management Focus on corruption at Daimler, for example, strongly suggests that paying bribes to secure business contracts was long viewed as an acceptable way of doing business within that company. It was, in the words of an investigator, "standard business practice" that permeated much of the organization, including departments such as auditing and finance that were meant to detect and halt such behavior. One can argue that such a widespread practice could have persisted only if the values and norms of the organization implicitly approved of paying bribes to secure business.

UNREALISTIC PERFORMANCE EXPECTATIONS

A fourth cause of unethical behavior has already been hinted at—pressure from the parent company to meet unrealistic performance goals that can be attained only by cutting corners or acting in an unethical manner. In the Daimler case, for example, bribery may have been viewed as a way to hit challenging performance goals. The combination of an organizational culture that legitimizes unethical behavior, or at least turns a blind eye to such behavior, and unrealistic performance goals may be particularly toxic. In such circumstances, there is a greater than average probability that managers will violate their own personal ethics and engage in unethical behavior. Conversely, an organization culture can do just the opposite and reinforce the need for ethical behavior. At Hewlett-Packard, for example, Bill Hewlett and David Packard, the company's founders, propagated a set of values known as The HP Way. These values, which shape the way business is conducted both within and by the corporation, have an important ethical component. Among other things, they stress the need for confidence in and respect for people, open communication, and concern for the individual employee.

LEADERSHIP

The Hewlett-Packard example suggests a fifth root cause of unethical behavior—leadership. Leaders help to establish the culture of an organization, and they set the example that others follow. Other employees in a business often take their cue from business leaders, and if those leaders do not behave in an ethical manner, they might not either. It is not just what leaders say that matters, but what they do or do not do. One wonders, for example, what message the leaders at Daimler sent about corrupt practices. Presumably, they did very little to discourage it and may well have encouraged such behavior.

SOCIETAL CULTURE

Societal culture may well have an impact on the propensity of people, and organizations, to behave in an unethical manner. One study of 2,700 firms in 24 countries found that there were significant differences among the ethical policies of firms headquartered in different countries.[31] Using Hofstede's dimensions of social culture (see the previous chapter), the study found that enterprises headquartered in cultures where individualism and uncertainty avoidance are strong were more likely to emphasize the importance of behaving ethically than firms headquartered in cultures where masculinity and power distance are important cultural attributes. Such analysis suggests that enterprises headquartered in a country such as Russia, which scores high on masculinity and power distance measures, and where corruption is endemic, are more likely to engage in unethical behavior than enterprises headquartered in Scandinavia.

Philosophical Approaches to Ethics LO4

We shall look at several different approaches to business ethics here, beginning with some that can best be described as straw men, which either deny the value of business ethics or apply the concept in a very unsatisfactory way. Having discussed, and dismissed, the straw men, we then move on to consider approaches that are favored by most moral

philosophers and form the basis for current models of ethical behavior in international businesses.

STRAW MEN

Straw men approaches to business ethics are raised by business ethics scholars primarily to demonstrate that they offer inappropriate guidelines for ethical decision making in a multinational enterprise. Four such approaches to business ethics are commonly discussed in the literature. These approaches can be characterized as the Friedman doctrine, cultural relativism, the righteous moralist, and the naive immoralist. All of these approaches have some inherent value, but all are unsatisfactory in important ways. Nevertheless, sometimes companies adopt these approaches.

The Friedman Doctrine

The Nobel Prize-winning economist Milton Friedman wrote an article in 1970 that has since become a classic straw man that business ethics scholars outline only to then tear down.[32] Friedman's basic position is that the only social responsibility of business is to increase profits, so long as the company stays within the rules of law. He explicitly rejects the idea that businesses should undertake social expenditures beyond those mandated by the law and required for the efficient running of a business. For example, his arguments suggest that improving working conditions beyond the level required by the law *and* necessary to maximize employee productivity will reduce profits and are therefore not appropriate. His belief is that a firm should maximize its profits because that is the way to maximize the returns that accrue to the owners of the firm, its stockholders. If stockholders then wish to use the proceeds to make social investments, that is their right, according to Friedman, but managers of the firm should not make that decision for them.

Although Friedman is talking about social responsibility, rather than business ethics per se, many business ethics scholars equate social responsibility with ethical behavior and thus believe Friedman is also arguing against business ethics. However, the assumption that Friedman is arguing against ethics is not quite true, for Friedman does state,

> There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say that it engages in open and free competition without deception or fraud.[33]

In other words, Friedman states that businesses should behave in an ethical manner and not engage in deception and fraud.

Nevertheless, Friedman's arguments do break down under examination. This is particularly true in international business, where the "rules of the game" are not well established and differ from country to county. Consider again the case of sweatshop labor. Child labor may not be against the law in a developing nation, and maximizing productivity may not require that a multinational firm stop using child labor in that country, but it is still immoral to use child labor because the practice conflicts with widely held views about what is the right and proper thing to do. Similarly, there may be no rules against pollution in a developed nation and spending money on pollution control may reduce the profit rate of the firm, but generalized notions of morality would hold that it is still unethical to dump toxic pollutants into rivers or foul the air with gas releases. In addition to the local consequences of such pollution, which may have serious health effects for the surrounding population, there is also a global consequence as pollutants degrade those two global commons so important to us all—the atmosphere and the oceans.

Cultural Relativism

Another straw man often raised by business ethics scholars is **cultural relativism**, which is the belief that ethics are nothing more than the reflection of a culture—all ethics are culturally determined—and that accordingly, a firm should adopt the ethics of the

culture in which it is operating.[34] This approach is often summarized by the maxim *when in Rome do as the Romans*. As with Friedman's approach, cultural relativism does not stand up to a closer look. At its extreme, cultural relativism suggests that if a culture supports slavery, it is OK to use slave labor in a country. Clearly, it is not! Cultural relativism implicitly rejects the idea that universal notions of morality transcend different cultures, but, as we shall argue later in the chapter, some universal notions of morality are found across cultures.

While dismissing cultural relativism in its most sweeping form, some ethicists argue there is residual value in this approach.[35] As we noted in Chapter 3, societal values and norms do vary from culture to culture, customs do differ, so it might follow that certain business practices are ethical in one country, but not another. Indeed, the facilitating payments allowed in the Foreign Corrupt Practices Act can be seen as an acknowledgment that in some countries, the payment of speed money to government officials is necessary to get business done, and if not ethically desirable, it is at least ethically acceptable.

However, not all ethicists or companies agree with this pragmatic view. As noted earlier, oil company BP explicitly states it will not make facilitating payments, no matter what the prevailing cultural norms are. BP has enacted a zero-tolerance policy for facilitation payments, primarily on the basis that such payments are a low-level form of corruption, and thus cannot be justified because corruption corrupts both the bribe giver and the bribe taker, and perpetuates the corrupt system. As BP notes on its website, because of its zero-tolerance policy:

> Some oil product sales in Vietnam involved inappropriate commission payments to the managers of customers in return for placing orders with BP. These were stopped during 2002 with the result that BP failed to win certain tenders with potential profit totalling $300,000. In addition, two sales managers resigned over the issue. The business, however, has recovered using more traditional sales methods and has exceeded its targets at year-end.[36]

BP's experience suggests that companies should not use cultural relativism as an argument for justifying behavior that is clearly based upon suspect ethical grounds, even if that behavior is both legal and routinely accepted in the country where the company is doing business.

The Righteous Moralist

A **righteous moralist** claims that a multinational's home-country standards of ethics are the appropriate ones for companies to follow in foreign countries. This approach is typically associated with managers from developed nations. While this seems reasonable at first blush, the approach can create problems. Consider the following example: An American bank manager was sent to Italy and was appalled to learn that the local branch's accounting department recommended grossly underreporting the bank's profits for income tax purposes.[37] The manager insisted that the bank report its earnings accurately, American style. When he was called by the Italian tax department to the firm's tax hearing, he was told the firm owed three times as much tax as it had paid, reflecting the department's standard assumption that each firm underreports its earnings by two-thirds. Despite his protests, the new assessment stood. In this case, the righteous moralist has run into a problem caused by the prevailing cultural norms in the country where he is doing business. How should he respond? The righteous moralist would argue for maintaining the position, while a more pragmatic view might be that in this case, the right thing to do is to follow the prevailing cultural norms, since there is a big penalty for not doing so.

The main criticism of the righteous moralist approach is that its proponents go too far. While there are some universal moral principles that should not be violated, it does not always follow that the appropriate thing to do is adopt home-country standards. For example, U.S. laws set down strict guidelines with regard to minimum wage and working

conditions. Does this mean it is ethical to apply the same guidelines in a foreign country, paying people the same as they are paid in the United States, providing the same benefits and working conditions? Probably not, because doing so might nullify the reason for investing in that country and therefore deny locals the benefits of inward investment by the multinational. Clearly, a more nuanced approach is needed.

The Naive Immoralist

A **naive immoralist** asserts that if a manager of a multinational sees that firms from other nations are not following ethical norms in a host nation, that manager should not either. The classic example to illustrate the approach is known as the drug lord problem. In one variant of this problem, an American manager in Colombia routinely pays off the local drug lord to guarantee that his plant will not be bombed and that none of his employees will be kidnapped. The manager argues that such payments are ethically defensible because everyone is doing it.

The objection is twofold. First, to say that an action is ethically justified if everyone is doing it is not sufficient. If firms in a country routinely employ 12-year-olds and makes them work 10-hour days, is it therefore ethically defensible to do the same? Obviously not, and the company does have a clear choice. It does not have to abide by local practices, and it can decide not to invest in a country where the practices are particularly odious. Second, the multinational must recognize that it does have the ability to change the prevailing practice in a country. It can use its power for a positive moral purpose. This is what BP is doing by adopting a zero-tolerance policy with regard to facilitating payments. BP is stating that the prevailing practice of making facilitating payments is ethically wrong, and it is incumbent upon the company to use its power to try to change the standard. While some might argue that such an approach smells of moral imperialism and a lack of cultural sensitivity, if it is consistent with widely accepted moral standards in the global community, it may be ethically justified.

To return to the drug lord problem, an argument can be made that it is ethically defensible to make such payments, not because everyone else is doing so but because not doing so would cause greater harm (i.e., the drug lord might seek retribution and engage in killings and kidnappings). Another solution to the problem is to refuse to invest in a country where the rule of law is so weak that drug lords can demand protection money. This solution, however, is also imperfect, for it might mean denying the law-abiding citizens of that country the benefits associated with inward investment by the multinational (i.e., jobs, income, greater economic growth and welfare). Clearly, the drug lord problem constitutes one of those intractable ethical dilemmas where there is no obvious right solution, and managers need a moral compass to help them find an acceptable solution to the dilemma.

UTILITARIAN AND KANTIAN ETHICS

In contrast to the straw men just discussed, most moral philosophers see value in utilitarian and Kantian approaches to business ethics. These approaches were developed in the eighteenth and nineteenth centuries and although they have been largely superseded by more modern approaches, they form part of the tradition upon which newer approaches have been constructed.

The utilitarian approach to business ethics dates to philosophers such as David Hume (1711–1776), Jeremy Bentham (1748–1832), and John Stuart Mill (1806–1873). **Utilitarian approaches** to ethics hold that the moral worth of actions or practices is determined by their consequences.[38] An action is judged desirable if it leads to the best possible balance of good consequences over bad consequences. Utilitarianism is committed to the maximization of good and the minimization of harm. Utilitarianism recognizes that actions have multiple consequences, some of which are good in a social sense and some of which are harmful. As a philosophy for business ethics, it focuses attention on

the need to weigh carefully all of the social benefits and costs of a business action and to pursue only those actions where the benefits outweigh the costs. The best decisions, from a utilitarian perspective, are those that produce the greatest good for the greatest number of people.

Many businesses have adopted specific tools such as cost–benefit analysis and risk assessment that are firmly rooted in a utilitarian philosophy. Managers often weigh the benefits and costs of an action before deciding whether to pursue it. An oil company considering drilling in the Alaskan wildlife preserve must weigh the economic benefits of increased oil production and the creation of jobs against the costs of environmental degradation in a fragile ecosystem. An agricultural biotechnology company such as Monsanto must decide whether the benefits of genetically modified crops that produce natural pesticides outweigh the risks. The benefits include increased crop yields and reduced need for chemical fertilizers. The risks include the possibility that Monsanto's insect-resistant crops might make matters worse over time if insects evolve a resistance to the natural pesticides engineered into Monsanto's plants, rendering the plants vulnerable to a new generation of super bugs.

For all of its appeal, utilitarian philosophy does have some serious drawbacks as an approach to business ethics. One problem is measuring the benefits, costs, and risks of a course of action. In the case of an oil company considering drilling in Alaska, how does one measure the potential harm done to the region's ecosystem? In the Monsanto example, how can one quantify the risk that genetically engineered crops might ultimately result in the evolution of super bugs that are resistant to the natural pesticide engineered into the crops? In general, utilitarian philosophers recognize that the measurement of benefits, costs, and risks is often not possible due to limited knowledge.

The second problem with utilitarianism is that the philosophy omits the consideration of justice. The action that produces the greatest good for the greatest number of people may result in the unjustified treatment of a minority. Such action cannot be ethical, precisely because it is unjust. For example, suppose that in the interests of keeping down health insurance costs, the government decides to screen people for the HIV virus and deny insurance coverage to those who are HIV positive. By reducing health costs, such action might produce significant benefits for a large number of people, but the action is unjust because it discriminates unfairly against a minority.

Kantian ethics are based on the philosophy of Immanuel Kant (1724–1804). **Kantian ethics** hold that people should be treated as ends and never purely as *means* to the ends of others. People are not instruments, like a machine. People have dignity and need to be respected as such. Employing people in sweatshops, making them work long hours for low pay in poor work conditions, is a violation of ethics, according to Kantian philosophy, because it treats people as mere cogs in a machine and not as conscious moral beings that have dignity. Although contemporary moral philosophers tend to view Kant's ethical philosophy as incomplete—for example, his system has no place for moral emotions or sentiments such as sympathy or caring—the notion that people should be respected and treated with dignity resonates in the modern world.

RIGHTS THEORIES

Developed in the twentieth century, **rights theories** recognize that human beings have fundamental rights and privileges that transcend national boundaries and cultures. Rights establish a minimum level of morally acceptable behavior. One well-known definition of a fundamental right construes it as something that takes precedence over or "trumps" a collective good. Thus, we might say that the right to free speech is a fundamental right that takes precedence over all but the most compelling collective goals and overrides, for example, the interest of the state in civil harmony or moral consensus.[39] Moral theorists argue that fundamental human rights form the basis for the *moral compass* that managers should navigate by when making decisions that have an ethical component. More precisely, they should not pursue actions that violate these rights.

The notion that there are fundamental rights that transcend national borders and cultures was the underlying motivation for the United Nations **Universal Declaration of Human Rights**, which has been ratified by almost every country on the planet and lays down basic principles that should always be adhered to irrespective of the culture in which one is doing business.[40] Echoing Kantian ethics, Article 1 of this declaration states:

> Article 1: All human beings are born free and equal in dignity and rights. They are endowed with reason and conscience and should act towards one another in a spirit of brotherhood.

Article 23 of this declaration, which relates directly to employment, states:

> Everyone has the right to work, to free choice of employment, to just and favorable conditions of work, and to protection against unemployment.
>
> Everyone, without any discrimination, has the right to equal pay for equal work.
>
> Everyone who works has the right to just and favorable remuneration ensuring for himself and his family an existence worthy of human dignity, and supplemented, if necessary, by other means of social protection.
>
> Everyone has the right to form and to join trade unions for the protection of his interests.

Clearly, the rights to "just and favorable work conditions," "equal pay for equal work," and remuneration that ensures an "existence worthy of human dignity" embodied in Article 23 imply that it is unethical to employ child labor in sweatshop settings and pay less than subsistence wages, even if that happens to be common practice in some countries. These are fundamental human rights that transcend national borders.

It is important to note that along with *rights* come *obligations*. Because we have the right to free speech, we are also obligated to make sure that we respect the free speech of others. The notion that people have obligations is stated in Article 29 of the Universal Declaration of Human Rights:

> Article 29: Everyone has duties to the community in which alone the free and full development of his personality is possible.

Within the framework of a theory of rights, certain people or institutions are obligated to provide benefits or services that secure the rights of others. Such obligations also fall upon more than one class of moral agent (a moral agent is any person or institution that is capable of moral action such as a government or corporation).



First lady Eleanor Roosevelt holds the Spanish-language version of the Universal Declaration of Human Rights, adopted by the United Nations in 1948.

For example, to escape the high costs of toxic waste disposal in the West, in the late 1980s several firms shipped their waste in bulk to African nations, where it was disposed of at a much lower cost. In 1987, five European ships unloaded toxic waste containing dangerous poisons in Nigeria. Workers wearing sandals and shorts unloaded the barrels for $2.50 a day and placed them in a dirt lot in a residential area. They were not told about the contents of the barrels.[41] Who bears the obligation for protecting the rights of workers and residents to safety in a case like this? According to rights theorists, the obligation rests not on the shoulders of one moral agent, but on the shoulders of all moral agents whose actions might harm or contribute to the harm of the workers and residents. Thus, it was the obligation not just of the Nigerian government but also of the multinational firms that shipped the toxic waste to make sure it did no harm to residents and workers. In this case, both the government

and the multinationals apparently failed to recognize their basic obligation to protect the fundamental human rights of others.

JUSTICE THEORIES

Justice theories focus on the attainment of a just distribution of economic goods and services. A **just distribution** is one that is considered fair and equitable. There is no one theory of justice, and several theories of justice conflict with each other in important ways.[42] Here we shall focus on one particular theory of justice that both is very influential and has important ethical implications. The theory is attributed to philosopher John Rawls.[43] Rawls argues that all economic goods and services should be distributed equally except when an unequal distribution would work to everyone's advantage.

According to Rawls, valid principles of justice are those with which all persons would agree if they could freely and impartially consider the situation. Impartiality is guaranteed by a conceptual device that Rawls calls the *veil of ignorance*. Under the veil of ignorance, everyone is imagined to be ignorant of all of his or her particular characteristics, for example, race, sex, intelligence, nationality, family background, and special talents. Rawls then asks what system people would design under a veil of ignorance. Under these conditions, people would unanimously agree on two fundamental principles of justice.

The first principle is that each person be permitted the maximum amount of basic liberty compatible with a similar liberty for others. Rawls takes these to be political liberty (e.g., the right to vote), freedom of speech and assembly, liberty of conscience and freedom of thought, the freedom and right to hold personal property, and freedom from arbitrary arrest and seizure.

The second principle is that once equal basic liberty is assured, inequality in basic social goods—such as income and wealth distribution, and opportunities—is to be allowed *only* if such inequalities benefit everyone. Rawls accepts that inequalities can be just if the system that produces inequalities is to the advantage of everyone. More precisely, he formulates what he calls the *difference principle*, which is that inequalities are justified if they benefit the position of the least-advantaged person. So, for example, wide variations in income and wealth can be considered just if the market-based system that produces this unequal distribution also benefits the least-advantaged members of society. One can argue that a well-regulated, market-based economy and free trade, by promoting economic growth, benefit the least-advantaged members of society. In principle at least, the inequalities inherent in such systems are therefore just (in other words, the rising tide of wealth created by a market-based economy and free trade lifts all boats, even those of the most disadvantaged).

In the context of international business ethics, Rawls's theory creates an interesting perspective. Managers could ask themselves whether the policies they adopt in foreign operations would be considered just under Rawls's veil of ignorance. Is it just, for example, to pay foreign workers less than workers in the firm's home country? Rawls's theory would suggest it is, so long as the inequality benefits the least-advantaged members of the global society (which is what economic theory suggests). Alternatively, it is difficult to imagine that managers operating under a veil of ignorance would design a system where foreign employees were paid subsistence wages to work long hours in sweatshop conditions and where they were exposed to toxic materials. Such working conditions are clearly unjust in Rawls's framework, and therefore, it is unethical to adopt them. Similarly, operating under a veil of ignorance, most people would probably design a system that imparts some protection from environmental degradation to important global commons, such as the oceans, atmosphere, and tropical rain forests. To the extent that this is the case, it follows that it is unjust, and by extension unethical, for companies to pursue actions that contribute toward extensive degradation of these commons. Thus, Rawls's veil of ignorance is a conceptual tool that contributes to the moral compass that managers can use to help them navigate through difficult ethical dilemmas.

IMPLICATIONS FOR MANAGERS

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What then is the best way for managers in a multinational firm to make sure that ethical considerations figure into international business decisions? How do managers decide upon an ethical course of action when confronted with decisions pertaining to working conditions, human rights, corruption, and environmental pollution? From an ethical perspective, how do managers determine the moral obligations that flow from the power of a multinational? In many cases, there are no easy answers to these questions, for many of the most vexing ethical problems arise because there are very real dilemmas inherent in them and no obvious correct action. Nevertheless, managers can and should do many things to make sure that basic ethical principles are adhered to and that ethical issues are routinely inserted into international business decisions.

Here we focus on five things that an international business and its managers can do to make sure ethical issues are considered in business decisions. These are: (1) favor hiring and promoting people with a well-grounded sense of personal ethics; (2) build an organizational culture that places a high value on ethical behavior; (3) make sure that leaders within the business not only articulate the rhetoric of ethical behavior, but also act in a manner that is consistent with that rhetoric; (4) put decision-making processes in place that require people to consider the ethical dimension of business decisions; and (5) develop moral courage.

HIRING AND PROMOTION

It seems obvious that businesses should strive to hire people who have a strong sense of personal ethics and would not engage in unethical or illegal behavior. Similarly, you would not expect a business to promote people, and perhaps to fire people, whose behavior does not match generally accepted ethical standards. However, actually doing so is very difficult. How do you know that someone has a poor sense of personal ethics? In our society, we have an incentive to hide a lack of personal ethics from public view. Once people realize that you are unethical, they will no longer trust you.

Is there anything that businesses can do to make sure they do not hire people who subsequently turn out to have poor personal ethics, particularly given that people have an incentive to hide this from public view (indeed, the unethical person may lie about his or her nature)? Businesses can give potential employees psychological tests to try to discern their ethical predisposition, and they can check with prior employees regarding someone's reputation (e.g., by asking for letters of reference and talking to people who have worked with the prospective employee). The latter is common and does influence the hiring process. Promoting people who have displayed poor ethics should not occur in a company where the organization culture values the need for ethical behavior and where leaders act accordingly.

Not only should businesses strive to identify and hire people with a strong sense of personal ethics, but it also is in the interests of prospective employees to find out as much as they can about the ethical climate in an organization. Who wants to work at a multinational such as Enron, which ultimately entered bankruptcy because unethical executives had established risky partnerships that were hidden from public view and that existed in part to enrich those same executives? Table 5.1 lists some questions job seekers might want to ask a prospective employer.

ORGANIZATION CULTURE AND LEADERSHIP

To foster ethical behavior, businesses need to build an organization culture that values ethical behavior. Three things are particularly important in building an organization culture that emphasizes ethical behavior. First, the businesses must explicitly articulate values

Some probing questions to ask about a prospective employer:
1. Is there a formal code of ethics? How widely is it distributed? Is it reinforced in other formal ways such as through decision-making systems?
2. Are workers at all levels trained in ethical decision making? Are they also encouraged to take responsibility for their behavior or to question authority when asked to do something they consider wrong?
3. Do employees have formal channels available to make their concerns known confidentially? Is there a formal committee high in the organization that considers ethical issues?
4. Is misconduct disciplined swiftly and justly within the organization?
5. Is integrity emphasized to new employees?
6. How are senior managers perceived by subordinates in terms of their integrity? How do such leaders model ethical behavior?

TABLE 5.1

A Job Seeker's Ethics Audit

Source: Linda K. Trevino, Chair of the Department of Management and Organization, Smeal College of Business, Pennsylvania State University. Reported in K. Maher, "Career Journal Wanted: Ethical Employer," *The Wall Street Journal*, July 9, 2002, p. B1. Copyright © 2002. Reproduced with permission of Dow Jones & Company, Inc. via Copyright Clearance Center.

that emphasize ethical behavior. Many companies now do this by drafting a **code of ethics**, which is a formal statement of the ethical priorities a business adheres to. Often, the code of ethics draws heavily upon documents such as the UN Universal Declaration of Human Rights, which itself is grounded in Kantian and rights-based theories of moral philosophy. Others have incorporated ethical statements into documents that articulate the values or mission of the business. For example, the food and consumer products multinational Unilever has a code of ethics that includes the following points:[44]

> **Employees:** Unilever is committed to diversity in a working environment where there is mutual trust and respect and where everyone feels responsible for the performance and reputation of our company. We will recruit, employ, and promote employees on the sole basis of the qualifications and abilities needed for the work to be performed. We are committed to safe and healthy working conditions for all employees. We will not use any form of forced, compulsory, or child labor. We are committed to working with employees to develop and enhance each individual's skills and capabilities. We respect the dignity of the individual and the right of employees to freedom of association. We will maintain good communications with employees through company-based information and consultation procedures.
>
> **Business Integrity:** Unilever does not give or receive, whether directly or indirectly, bribes or other improper advantages for business or financial gain. No employee may offer, give, or receive any gift or payment which is, or may be construed as being, a bribe. Any demand for, or offer of, a bribe must be rejected immediately and reported to management. Unilever accounting records and supporting documents must accurately describe and reflect the nature of the underlying transactions. No undisclosed or unrecorded account, fund, or asset will be established or maintained.

It is clear from these principles that among other things, Unilever will not tolerate substandard working conditions, use child labor, or give bribes under any circumstances. Note also the reference to respecting the dignity of employees, a statement that is grounded in Kantian ethics. Unilever's principles send a very clear message about appropriate ethics to managers and employees.

Having articulated values in a code of ethics or some other document, leaders in the business must give life and meaning to those words by repeatedly emphasizing their importance *and then acting on them.* This means using every relevant opportunity to stress the importance of business ethics and making sure that key business decisions not only make good economic sense but also are ethical. Many companies have gone a step further, hiring independent auditors to make sure they are behaving in a manner consistent with their ethical codes. Nike, for example, has hired independent auditors to

make sure that subcontractors used by the company are living up to Nike's code of conduct.

Finally, building an organization culture that places a high value on ethical behavior requires incentive and reward systems, including promotions that reward people who engage in ethical behavior and sanction those who do not. At General Electric, for example, the former CEO Jack Welch has described how he reviewed the performance of managers, dividing them into several different groups. These included over-performers who displayed the right values and were singled out for advancement and bonuses and over-performers who displayed the wrong values and were let go. Welch was not willing to tolerate leaders within the company who did not act in accordance with the central values of the company, even if they were in all other respects skilled managers.[45]

DECISION-MAKING PROCESSES

In addition to establishing the right kind of ethical culture in an organization, businesspeople must be able to think through the ethical implications of decisions in a systematic way. To do this, they need a moral compass, and both rights theories and Rawls's theory of justice help to provide such a compass. Beyond these theories, some experts on ethics have proposed a straightforward practical guide—or ethical algorithm—to determine whether a decision is ethical.[46] According to these experts, a decision is acceptable on ethical grounds if a businessperson can answer yes to each of these questions:

- Does my decision fall within the accepted values or standards that typically apply in the organizational environment (as articulated in a code of ethics or some other corporate statement)?
- Am I willing to see the decision communicated to all stakeholders affected by it—for example, by having it reported in newspapers or on television?
- Would the people with whom I have a significant personal relationship, such as family members, friends, or even managers in other businesses, approve of the decision?

Others have recommended a five-step process to think through ethical problems (this is another example of an ethical algorithm).[47] In step 1, businesspeople should identify which stakeholders a decision would affect and in what ways. A firm's **stakeholders** are individuals or groups that have an interest, claim, or stake in the company, in what it does, and in how well it performs.[48] They can be divided into internal stakeholders and external stakeholders. **Internal stakeholders** are individuals or groups who work for or own the business. They include all employees, the board of directors, and stockholders. **External stakeholders** are all other individuals and groups that have some claim on the firm. Typically, this group comprises customers, suppliers, lenders, governments, unions, local communities, and the general public.

All stakeholders are in an exchange relationship with the company. Each stakeholder group supplies the organization with important resources (or contributions), and in exchange each expects its interests to be satisfied (by inducements).[49] For example, employees provide labor, skills, knowledge, and time and in exchange expect commensurate income, job satisfaction, job security, and good working conditions. Customers provide a company with its revenues and in exchange they want quality products that represent value for money. Communities provide businesses with local infrastructure and in exchange they want businesses that are responsible citizens and seek some assurance that the quality of life will be improved as a result of the business firm's existence.

Stakeholder analysis involves a certain amount of what has been called *moral imagination*.[50] This means standing in the shoes of a stakeholder and asking how a proposed decision might impact that stakeholder. For example, when considering outsourcing to subcontractors, managers might need to ask themselves how it might feel to be working under substandard health conditions for long hours.

Step 2 involves judging the ethics of the proposed strategic decision, given the information gained in step 1. Managers need to determine whether a proposed decision would violate the *fundamental rights* of any stakeholders. For example, we might argue that the right to information about health risks in the workplace is a fundamental entitlement of employees. Similarly, the right to know about potentially dangerous features of a product is a fundamental entitlement of customers (something tobacco companies violated when they did not reveal to their customers what they knew about the health risks of smoking). Managers might also want to ask themselves whether they would allow the proposed strategic decision if they were designing a system under Rawls's veil of ignorance. For example, if the issue under consideration was whether to outsource work to a subcontractor with low pay and poor working conditions, managers might want to ask themselves whether they would allow for such action if they were considering it under a veil of ignorance, where they themselves might ultimately be the ones to work for the subcontractor.

The judgment at this stage should be guided by various moral principles that should not be violated. The principles might be those articulated in a corporate code of ethics or other company documents. In addition, certain moral principles that we have adopted as members of society—for instance, the prohibition on stealing—should not be violated. The judgment at this stage will also be guided by the decision rule that is chosen to assess the proposed strategic decision. Although maximizing long-run profitability is the decision rule that most businesses stress, it should be applied subject to the constraint that no moral principles are violated—that the business behaves in an ethical manner.

Step 3 requires managers to establish moral intent. This means the business must resolve to place moral concerns ahead of other concerns in cases where either the fundamental rights of stakeholders or key moral principles have been violated. At this stage, input from top management might be particularly valuable. Without the proactive encouragement of top managers, middle-level managers might tend to place the narrow economic interests of the company before the interests of stakeholders. They might do so in the (usually erroneous) belief that top managers favor such an approach.

Step 4 requires the company to engage in ethical behavior. Step 5 requires the business to audit its decisions, reviewing them to make sure they were consistent with ethical principles, such as those stated in the company's code of ethics. This final step is critical and often overlooked. Without auditing past decisions, businesspeople may not know if their decision process is working and if changes should be made to ensure greater compliance with a code of ethics.

ETHICS OFFICERS

To make sure that a business behaves in an ethical manner, a number of firms now have ethics officers. These individuals are responsible for making sure that all employees are trained to be ethically aware, that ethical considerations enter the business decision-making process, and that the company's code of ethics is followed. Ethics officers may also be responsible for auditing decisions to make sure they are consistent with this code. In many businesses, ethics officers act as an internal ombudsperson with responsibility for handling confidential inquiries from employees, investigating complaints from employees or others, reporting findings, and making recommendations for change.

For example, United Technologies, a multinational aerospace company with worldwide revenues of more than $30 billion, has had a formal code of ethics since 1990.[51] United Technologies has some 160 business practice officers (the company's name for ethics officers). They are responsible for making sure the code is followed. United Technologies also established an ombudsperson program in 1986 that lets employees inquire anonymously about ethics issues. The program has received some 60,000 inquiries since 1986, and over 10,000 cases have been handled by an ombudsperson.



United Technologies, the maker of Sikorsky helicopters, demonstrates commitment to ethical behavior by employing some 160 business practices officers.

MORAL COURAGE

Finally, it is important to recognize that employees in an international business may need significant *moral courage.* Moral courage enables managers to walk away from a decision that is profitable but unethical. Moral courage gives an employee the strength to say no to a superior who instructs her to pursue actions that are unethical. Moral courage gives employees the integrity to go public to the media and blow the whistle on persistent unethical behavior in a company. Moral courage does not come easily; there are well-known cases where individuals have lost their jobs because they blew the whistle on corporate behaviors they thought unethical, telling the media about what was occurring.[52]

However, companies can strengthen the moral courage of employees by committing themselves to not retaliate against employees who exercise moral courage, say no to superiors, or otherwise complain about unethical actions. For example, consider the following extract from Unilever's code of ethics:

> Any breaches of the Code must be reported in accordance with the procedures specified by the Joint Secretaries. The Board of Unilever will not criticize management for any loss of business resulting from adherence to these principles and other mandatory policies and instructions. The Board of Unilever expects employees to bring to their attention, or to that of senior management, any breach or suspected breach of these principles. Provision has been made for employees to be able to report in confidence and no employee will suffer as a consequence of doing so.[53]

This statement gives permission to employees to exercise moral courage. Companies can also set up ethics hotlines, which allow employees to anonymously register a complaint with a corporate ethics officer.

SUMMARY OF DECISION-MAKING STEPS

All the steps discussed here—hiring and promoting people based upon ethical considerations as well as more traditional metrics of performance, establishing an ethical culture in the organization, instituting ethical decision-making processes, appointing ethics officers, and creating an environment that facilitates moral courage—can help to make sure that when making business decisions, managers are cognizant of the ethical implications and do not violate basic ethical prescripts. At the same time, it must be recognized that not all ethical dilemmas have a clean and obvious solution—that is why they are dilemmas. There are clearly things that international businesses should not do and there are things that they should do but there are also actions that present managers with true dilemmas. In these cases, a premium is placed on managers' ability to make sense out of complex situations and make balanced decisions that are as just as possible.

CHAPTER SUMMARY

This chapter discussed the source and nature of ethical issues in international businesses, the different philosophical approaches to business ethics, and the steps managers can take to ensure that ethical issues are respected in international business decisions. The chapter made the following points:

1. The term *ethics* refers to accepted principles of right or wrong that govern the conduct of a person, the members of a profession, or the actions of an organization. Business ethics are the accepted principles of right or wrong governing the conduct of businesspeople, and an ethical strategy is one that does not violate these accepted principles.
2. Ethical issues and dilemmas in international business are rooted in the variations among political systems, law, economic development, and culture from nation to nation.
3. The most common ethical issues in international business involve employment practices, human rights, environmental regulations, corruption, and the moral obligation of multinational corporations.
4. Ethical dilemmas are situations in which none of the available alternatives seems ethically acceptable.
5. Unethical behavior is rooted in poor personal ethics, societal culture, the psychological and geographical distances of a foreign subsidiary from the home office, a failure to incorporate ethical issues into strategic and operational decision making, a dysfunctional culture, and failure of leaders to act in an ethical manner.
6. Moral philosophers contend that approaches to business ethics such as the Friedman doctrine, cultural relativism, the righteous moralist, and the naive immoralist are unsatisfactory in important ways.
7. The Friedman doctrine states that the only social responsibility of business is to increase profits, as long as the company stays within the rules of law. Cultural relativism contends that one should adopt the ethics of the culture in which one is doing business. The righteous moralist monolithically applies home-country ethics to a foreign situation, while the naive immoralist believes that if a manager of a multinational sees that firms from other nations are not following ethical norms in a host nation, that manager should not either.
8. Utilitarian approaches to ethics hold that the moral worth of actions or practices is determined by their consequences, and the best decisions are those that produce the greatest good for the greatest number of people.
9. Kantian ethics state that people should be treated as ends and never purely as *means* to the ends of others. People are not instruments, like a machine. People have dignity and need to be respected as such.
10. Rights theories recognize that human beings have fundamental rights and privileges that transcend national boundaries and cultures. These rights establish a minimum level of morally acceptable behavior.
11. The concept of justice developed by John Rawls suggests that a decision is just and ethical if people would allow for it when designing a social system under a veil of ignorance.
12. To make sure that ethical issues are considered in international business decisions, managers should (*a*) favor hiring and promoting people with a well-grounded sense of personal ethics; (*b*) build an organization culture that places a high value on ethical behavior; (*c*) make sure that leaders within the business not only articulate the rhetoric of ethical behavior, but also act in a manner that is consistent with that rhetoric; (*d*) put decision-making processes in place that require people to consider the ethical dimension of business decisions; and (*e*) be morally courageous and encourage others to do the same.

Critical Thinking and Discussion Questions

1. A visiting American executive finds that a foreign subsidiary in a poor nation has hired a 12-year-old girl to work on a factory floor, in violation of the company's prohibition on child labor. He tells the local manager to replace the child and tell her to go back to school. The local manager tells the American executive that the child is an orphan with no other means of support, and she will probably become a street child if she is denied work. What should the American executive do?

2. Drawing upon John Rawls's concept of the veil of ignorance, develop an ethical code that will (*a*) guide the decisions of a large oil multinational toward environmental protection, and (*b*) influence the policies of a clothing company to outsourcing of manufacturing process.
3. Under what conditions is it ethically defensible to outsource production to the developing world where labor costs are lower when such actions also involve laying off long-term employees in the firm's home country?
4. Are facilitating payments (*speed payments*) ethical?
5. A manager from a developing country is overseeing a multinational's operations in a country where drug trafficking and lawlessness are rife. One day, a representative of a local "big man" approaches the manager and asks for a "donation" to help the big man provide housing for the poor. The representative tells the manager that in return for the donation, the big man will make sure that the manager has a productive stay in his country. No threats are made, but the manager is well aware that the big man heads a criminal organization that is engaged in drug trafficking. He also knows that that the big man does indeed help the poor in the run-down neighborhood of the city where he was born. What should the manager do?
6. Reread the Management Focus on Unocal and answer the following questions:
   a. Was it ethical for Unocal to enter into a partnership with a brutal military dictatorship for financial gain?
   b. What actions could Unocal have taken, short of not investing at all, to safeguard the human rights of people impacted by the gas pipeline project?

Research Task globalEDGE globaledge.msu.edu

Ethics in International Business

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

Promoting respect for universal human rights is a central dimension of many countries' foreign policy. As history has shown, human rights abuses are an important concern worldwide. Some countries are more ready to work with other governments and civil society organizations to prevent abuses of power. Begun in 1977, the annual *Country Reports on Human Rights Practices* are designed to assess the state of democracy and human rights around the world, call attention to violations, and—where needed—prompt needed changes in U.S. policies toward particular countries. Find the annual Country Reports on Human Right Practices and provide information on how the reports are prepared.

Exercise 2

The level of perceived corruption varies from culture to culture. The *Corruption Perceptions Index (CPI)* is a comparative assessment of a country's integrity performance based on research done by Transparency International. Provide a description of this index and its ranking. Identify the five countries with the lowest as well as the highest CPI scores. Do you notice any similarities or differences in each group of five countries?

CLOSING CASE

Knights Apparel

Some years ago Joseph Bozich was watching his son play in a high school basketball game when his vision started to become blurred. A day later he couldn't read. His doctor suspected that Bozich had a brain tumor, but tests revealed that the cause was multiple sclerosis. Luckily for Bozich, his vision improved, and he has not suffered another attack, but the incident left him with a desire to do something important in life—to somehow make a contribution to humanity.

As founder and CEO of Knights Apparel, a privately held company, Bozich realized he had the power to make such a contribution. A former U.S. collegiate bodybuilding

champion, Bozich got his start in apparel working for Gold's Gym, selling branded clothing to outside retailers. In 2000 he founded Knights Apparel and started to build a business selling athletic clothing with college logos to universities around America. Like most organizations in the apparel industry, Bozich relied on a network of foreign suppliers to manufacture his products. The apparel industry is often accused of using sweatshop suppliers based in poor nations where pay is low, hours are long, and working conditions are awful. In 2005, Bozich wondered if it might be possible to change this—to source product from less developed nations but to do so in a more ethical way, paying employees a decent wage and providing them with good working conditions.

After some investigation, Bozich decided to establish his own "model factory" in the Dominican Republic. He purchased a factory that had previously been used by a Korean company to make baseball caps for Nike and Reebok. The Korean company had moved production to a lower-wage country in 2007, throwing some 1,200 out of work. The factory now produces under a new label, Alta Gracia, which is derived from the name of the local town, Ville Altagracia, and means "exalted grace." The minimum wage in the area is $147 a month, a figure so low that it is insufficient to live on. Bozich's factory pays its workers more than 3.5 times this amount. According a study done by a workers' rights group, this is the pay level required to support a family of four in the region. Bozich has allowed his employees to unionize and has made investments in safety and good working conditions a priority. Knights Apparel invested some $500,000 in upgrading the factory with features that include bright lights, five new sewing lines, and ergonomic chairs for employees, which many seamstresses thought were for the managers.

Clearly the higher pay translates into higher costs. Bozich calculates that the factory's cost per unit of clothing is 20 percent higher than if it paid the minimum wage. Given the competitive nature of the market for apparel, Knights cannot pass this cost increase on to wholesalers and retailers in the form of higher prices, so Bozich has elected to take smaller profit margins. For a product such as a basic T-shirt with a logo, the manufacturing cost at Alta Gracia is $4.80, about 80 cents more than if the pay was minimum wage. The shirt is sold for $8 to wholesalers, with most retailers marking them up to about $18.

Bozich realizes he has a strong marketing message built around "fair labor." This is particularly useful selling into colleges. Student groups have often agitated for boycotts against companies such as Nike and Reebok for using sweatshop labor. (Since being the target of protests in the 1990s, Nike has put rigorous procedures in place for auditing the operations of suppliers to make sure they adhere to Nike's own code of ethics for suppliers.) The "fair labor" marketing message seems to be resonating with colleges. Several universities have backed the project. Duke University's bookstore, for example, placed an initial order for $25,000 of merchandise. Barnes & Noble College Booksellers planned to have Alta Gracia products at some 350 stores in college campuses by early 2011. Barnes & Noble plans to promote the product heavily and expects to take lower margins to begin with. The United Students Against Sweatshops, a nationwide student group that often attacks apparel manufacturers, has also backed the project and has been distributing flyers at college bookstores urging students to purchase the Alta Gracia shirts. Companies such as Nike and Reebok that also serve the college market are reportedly watching what happens carefully.[54]

Case Discussion Questions

1. The case states that higher wage rates at the Alta Gracia factory have raised the cost per item by 20 percent. Can you see any way in which the philosophy with regard to pay and working conditions at Alta Gracia might lower costs in the long run?
2. Do you think Joseph Bozich would have been able to try the Alta Gracia experiment if Knights Apparel was a publicly traded enterprise?
3. What do you think might stand in the way of Alta Gracia becoming successful? What strategies might Bozich adopt to minimize the risk of failure while still adhering to his high ethical standards?
4. Alta Gracia serves a niche market, colleges, where there is higher awareness of ethical issues in apparel production. Do you think the strategy would work if the company tried to sell to the mass market through retailers such as Walmart?
5. Is it ethical for apparel companies to move production around the world in pursuit of the lowest possible labor costs, even if that means paying wage rates that are below a living wage? What if the alternative is not to produce at all?
6. To what extent does the Alta Gracia experiment suggest that good ethics are also good business practice?

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Siemens Bribery Scandal

In December 2008 Siemens, the large German electronics firm, agreed to pay $1.6 billion in fines to settle legal suits bought by the U.S. and German governments. The governments asserted that Siemens had used bribes to win business in countries around the world. These were the largest fines ever levied against a company for bribes, reflecting the scale of the problem at Siemens. Since 1999, the company had apparently paid some $1.4 billion in bribes. In Bangladesh, Siemens paid $5 million to the son of the prime minister to win a mobile phone contract. In Nigeria, it paid $12.7 million to various officials to win government telecommunications contracts. In Argentina, Siemens paid at least $40 million in bribes to win a $1 billion contract to produce national identity cards. In Israel, the company "provided" $20 million to senior government officials in order to win a contract to build power plants. In China, it paid $14 million to government officials to win a contract to supply medical equipment. And so on.

Corruption at Siemens was apparently deeply embedded in the business culture. Before 1999, bribery of foreign officials was not illegal in Germany, and bribes could be deducted as a business expense under the German tax code. In this permissive environment, Siemens subscribed to the straightforward rule of adhering to local practices. If bribery was common in a country, Siemens would routinely use bribes to win business. Inside Siemens, bribes were referred to as "useful money."

When the German law changed in 1999, Siemens carried on as before, but put in place elaborate mechanisms to hide what it was doing. Money was transferred into hard to trace bank accounts in Switzerland. These funds were then used to hire an outside "consultant" to help win a contract. The consultant would in turn deliver the cash to the ultimate recipient, typically a government official. Siemens apparently had more than 2,700 such consultants worldwide. Bribes, which were viewed as a cost of doing business, typically ranged between 5 and 6 percent of a contract's value, although in corrupt countries bribes could be as much as 40 percent of the value of a contract. In justifying this behavior, one former Siemens employee stated, "It was about keeping the business alive and not jeopardizing thousands of jobs overnight." But the practice left behind angry competitors who were shut out of contracts and local residents in poor countries who paid too much for government services because of rigged deals. Also, by engaging in bribery, Siemens helped to foster a culture of corruption in those countries where it made illegal payouts.

During this time period, in a cynical move, Siemens put in place a formal process for monitoring payments to make sure that no illegal payments were made. Senior executives even made some of the individuals responsible for managing the bribery funds sign compliance forms stating that they had not engaged in any such activity, while knowing full well that this was not the case.

This scheme began to collapse at Siemens when investigators in several countries began to examine suspicious transactions. Prosecutors in Italy, Liechtenstein, and Switzerland sent requests for help to counterparts in Germany, providing a list of Siemens employees who were implicated in making illegal payments. In late 2006 the German police acted, raiding the company, seizing data, and arresting several executives. Shortly afterward, the United States started to look into these charges. Since Siemens had a listing on the New York Stock Exchange, it had to adhere to the Foreign Corrupt Practices Act, which outlaws payments to government officials to win contracts. At the end of the day, Siemens had to pay not only $1.6 billion in fines, but also commit to spending another $1 billion to improve its internal compliance process, while several executives went to jail.[1]

Case Discussion Questions

1. What explains the high level of corruption at Siemens? How did managers engaged in corruption rationalize it?
2. What do you think would have happened to a manager at Siemens if he or she had taken a stand against corrupt practices?
3. How does the kind of corruption Siemens engaged in distort competition?
4. What is the impact of corrupt behavior by Siemens on the countries where it does business?
5. If you were a manager at Siemens, and you became aware of these activities, what would you have done?

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Walmart's Foreign Expansion

Walmart, the world's largest retailer, has built its success on a strategy of everyday low prices and highly efficient operations, logistics, and information systems that keep inventory to a minimum and ensure against both overstocking and understocking. The company employs some 2.1 million people, operates 4,200 stores in the United States and 3,600 in the rest of the world, and generated sales of almost $400 billion in fiscal 2008. Some $91 billion of these sales were generated in 15 nations outside of the United States. Facing a slowdown in growth in the United States, Walmart began its international expansion in the early 1990s when it entered Mexico, teaming up in a joint venture with Cifra, Mexico's largest retailer, to open a series of super-centers that sell both groceries and general merchandise.

Initially the retailer hit some headwinds in Mexico. It quickly discovered that shopping habits were different. Most people preferred to buy fresh produce at local stores, particularly items such as meat, tortillas, and pan dulce, which didn't keep well overnight (many Mexicans lacked large refrigerators). Many consumers also lacked cars and did not buy in large volumes as in the United States. Walmart adjusted its strategy to meet the local conditions, hiring local managers who understood Mexican culture, letting those managers control merchandising strategy, building smaller stores that people could walk to, and offering more fresh produce. At the same time, the company believed it could gradually change the shopping culture in Mexico, educating consumers by showing them the benefits of its American merchandising culture. After all, Walmart's managers reasoned, people once shopped at small stores in the United States, but starting in the 1950s they increasingly gravitated toward large stores such as Walmart. As it built up its distribution systems in Mexico, Walmart was able to lower its costs, and it passed these savings on to Mexican consumers in the form of lower prices. The customization, persistence, and low prices paid off. Mexicans started to change their shopping habits. Today Walmart is Mexico's largest retailer and the country is widely considered to be the company's most successful foreign venture.

Next Walmart expanded into a number of developed nations, including Britain, Germany, and South Korea. There its experiences have been less successful. In all three countries it found itself going head to head against well-established local rivals that had nicely matched their offerings to local shopping habits and consumer preferences. Moreover, consumers in all three countries seemed to have a preference for higher-quality merchandise and were not as attracted to Walmart's discount strategy as consumers were in the United States and Mexico. After years of losses, Walmart pulled out of Germany and South Korea in 2006. At the same time, it continued to look for retailing opportunities elsewhere, particularly in developed nations where it lacked strong local competitors, where it could gradually alter the shopping culture to its advantage, and where its low-price strategy was appealing.

Recently, the centerpiece of its international expansion efforts has been China. Walmart opened its first store in China in 1996, but initially expanded very slowly, and by 2006 had only 66 stores. Walmart discovered the Chinese were bargain hunters and open to the low-price strategy and wide selection offered at Walmart stores. In terms of their shopping habits, the emerging Chinese middle class seemed more like Americans than Europeans. But to succeed in China, Walmart also found it had to adapt its merchandising and operations strategy so that it meshes with Chinese culture. For example, Walmart has learned Chinese consumers insist that food must be freshly harvested or even killed in front of them. Walmart initially offended Chinese consumers by trying to sell them dead fish, as well as meat packed in Styrofoam and cellophane. Shoppers turned their noses up at what they saw as old merchandise. So Walmart began to display the meat uncovered, installed fish tanks into which shoppers could plunge fishing nets to pull out their evening meal, and began selling live turtles for turtle soup. Sales soared.

Walmart has also learned that in China, success requires it to embrace unions. In the United States Walmart has vigorously resisted unionization, but it realized that in China unions don't bargain for labor contracts. Instead, they are an arm of the state, providing funding for the Communist Party and (in the government's view) securing social order. In mid-2006 Walmart broke with its long-standing antagonism to unions and agreed to allow unions in its Chinese stores. Many believe this set the stage for Walmart's December 2006 purchase of a 35 percent stake in the Trust-Mart chain, which has 101 hypermarkets in 34 cities across China. Now Walmart has proclaimed that China lies at the center of its growth strategy. By early 2009 Walmart had some 243 stores in the country, and despite the global economic slowdown, the company insists that it will continue to open new stores in China at a "double-digit rate."[1]

Case Discussion Questions

1. Do you think Walmart could translate its merchandising strategy wholesale to another country and succeed? If not, why not?
2. Why do you think Walmart was successful in Mexico?

3. Why do you think Walmart failed in South Korea and Germany? What are the differences between these countries and Mexico?
4. What must Walmart do to succeed in China? Is it on track?
5. To what extent can a company such as Walmart change the culture of the nation where it is doing business?

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Nike: The Sweatshop Debate

Nike is in many ways the quintessential global corporation. Established in 1972 by former University of Oregon track star Phil Knight, Nike is now one of the leading marketers of athletic shoes and apparel on the planet. Today the company has $20 billion in annual revenues and sells its products in some 140 countries. Nike does not do any manufacturing. Rather, it designs and markets its products, while contracting for their manufacture from a global network of 600 factories scattered around the globe that employ some 650,000 people.[1] This huge corporation has made Knight into one of the richest people in America. Nike's marketing phrase, "Just Do It!" has become as recognizable in popular culture as its "swoosh" logo or the faces of its celebrity sponsors, such as Michael Jordan and Tiger Woods.

For all of its successes, the company was dogged for more than a decade by repeated and persistent accusations that its products were made in "sweatshops" where workers, many of them children, slaved away in hazardous conditions for below-subsistence wages. Nike's wealth, its detractors claimed, was built upon the backs of the world's poor. For many, Nike had become a symbol of the evils of globalization—a rich Western corporation exploiting the world's poor to provide expensive shoes and apparel to the pampered consumers of the developed world. Niketown stores became standard targets for antiglobalization protesters. Several nongovernmental organizations, such as San Francisco-based Global Exchange, a human rights organization dedicated to promoting environmental, political, and social justice around the world, targeted Nike for repeated criticism and protests.[2] News shows such as CBS-TV's *48 Hours* ran exposés on working conditions in foreign factories that supply Nike. Students on the campuses of several major U.S. universities with which Nike had lucrative sponsorship deals protested against the ties, citing Nike's use of sweatshop labor.

For its part, Nike took many steps to try to counter the protests. Yes, it admitted, there were problems in some overseas factories. But the company signaled a commitment to improving working conditions. It required that foreign subcontractors meet minimum thresholds for working conditions and pay. It arranged for factories to be examined by independent auditors. It terminated contracts with factories that did not comply with its standards. But for all this effort, the company continues to be a target of protests and a symbol of dissent.

THE CASE AGAINST NIKE

Typical of the exposés against Nike was a CBS-TV *48 Hours* news report that aired October 17, 1996.[3] Reporter Roberta Basin visited a Nike factory in Vietnam. With a shot of the factory, her commentary began:

> The signs are everywhere of an American invasion in search of cheap labor. Millions of people who are literate, disciplined, and desperate for jobs. This is Nike Town near what use to be called Saigon, one of four factories Nike doesn't own but subcontracts to make a million shoes a month. It takes 25,000 workers, mostly young women, to "Just Do It."
>
> But the workers here don't share in Nike's huge profits. They work six days a week for only $40 a month, just 20 cents an hour.

Baskin interviewed one of the workers in the factory, a young woman named Lap. Baskin tells the listener:

> Her basic wage, even as sewing team leader, still doesn't amount to the minimum wage . . . . She's down to 85 pounds. Like most of the young women who make shoes, she has little choice but to accept the low wages and long hours. Nike says that it requires all subcontractors to obey local laws; but Lap has already put in much more overtime than the annual legal limit: 200 hours.

[1]From Nike's corporate website at www.nikebiz.com.
[2]www.globalexchange.org.
[3]"Boycott Nike" CBS News *48 Hours*, October 17, 1996.

Baskin then asks Lap what would happen if she wanted to leave. If she was sick or had something she needed to take care off such as a sick relative, could she leave the factory? Through a translator, Lap replies:

> It is not possible if you haven't made enough shoes. You have to meet the quota before you can go home.

The clear implication of the story was that Nike was at fault here for allowing such working conditions to persist in the Vietnam factory, which was owned by a South Korean company.

Another attack on Nike's subcontracting practices came in June 1996 from Made in the USA, a foundation largely financed by labor unions and domestic apparel manufacturers that oppose free trade with low-wage countries. According to Joel Joseph, chairman of the foundation, a popular line of high-priced Nike sneakers, the Air Jordans, were put together made by 11-year-olds in Indonesia making 14 cents per hour. Nike spokeswoman Donna Gibbs countered that this was not true. According to Gibbs, the average worker made 240,000 rupiah ($103) a month working a maximum 54-hour week, or about 45 cents per hour. Moreover, Gibbs noted that Nike had staff members in each factory monitoring conditions to make sure that they obeyed local minimum wage and child labor laws.[4]

Another example of the criticism against Nike is the following extracts from a newsletter published by Global Exchange:[5]

> During the 1970s, most Nike shoes were made in South Korea and Taiwan. When workers there gained new freedom to organize and wages began to rise, Nike looked for "greener pastures." It found them in Indonesia and China, where Nike started producing in the 1980s, and most recently in Vietnam.
>
> The majority of Nike shoes are made in Indonesia and China, countries with governments that prohibit independent unions and set the minimum wage at rock bottom. The Indonesian government admits that the minimum wage there does not provide enough to supply the basic needs of one person, let alone a family. In early 1997 the entry-level wage was a miserable $2.46 a day. Labor groups estimate that a livable wage in Indonesia is about $4.00 a day.
>
> In Vietnam the pay is even less—20 cents an hour, or a mere $1.60 a day. But in urban Vietnam, three simple meals cost about $2.10 a day, and then of course there is rent, transportation, clothing, health care, and much more. According to Thuyen Nguyen of Vietnam Labor Watch, a living wage in Vietnam is at least $3 a day.

In another attack on Nike's practices, in September 1997 Global Exchange published a report on working conditions in four Nike and Reebok subcontractors in southern China.[6] Global Exchange, in conjunction with two Hong Kong human rights groups, had interviewed workers at the factories in 1995 and again in 1997. According to Global Exchange, in one factory, a Korean-owned subcontractor for Nike, workers as young as 13 earned as little as 10 cents an hour and toiled up to 17 hours daily in enforced silence. Talking during work was not allowed, with violators fined $1.20 to $3.60 according to the report. The practices violated Chinese labor law, which states that no child under 16 may work in a factory, and the Chinese minimum wage requirement of $1.90 for an eight-hour day. Nike condemned the study as "erroneous," stating the report incorrectly stated the wages of workers and made irresponsible accusations.

Global Exchange, however, continued to be a major thorn in Nike's side. In November 1997, the organization obtained and then leaked a confidential report by Ernst & Young of an audit that Nike had commissioned of a factory in Vietnam owned by a Nike subcontractor.[7] The factory had 9,200 workers and made 400,000 pairs of shoes a month. The Ernst & Young report painted a dismal picture of thousands of young women, most under age 25, laboring 10½ hours a day, six days a week, in excessive heat and noise and in foul air, for slightly more than $10 a week. The report also found that workers with skin or breathing problems had not been transferred to departments free of chemicals and that more than half the workers who dealt with dangerous chemicals did not wear protective masks or gloves. It claimed workers were exposed to carcinogens that exceeded local legal standards by 177 times in parts of the plant and that 77 percent of the employees suffered from respiratory problems.

Put on the defensive yet again, Nike called a news conference and pointed out that it had commissioned the report, and had acted on it.[8] The company stated it had formulated an action plan to deal with the problems cited in the report, and had slashed overtime, improved safety and ventilation, and reduced the use of toxic chemicals. The company also asserted that the report showed that its internal monitoring system had performed exactly as it should have. According to one spokesman:

> "This shows our system of monitoring works . . . We have uncovered these issues clearly before anyone else, and we have moved fairly expeditiously to correct them."

[4]D. Jones, "Critics Tie Sweatshop Sneakers to Air Jordan," *USA Today*, June 6, 1996, p. 1B.
[5]Global Exchange Special Report: "Nike Just Don't do It," http://www.globalexchange.org/education/publications/newsltr6.97p2.html#nike.
[6]V. Dobnik, "Chinese Workers Abused Making Nikes, Reeboks," *Seattle Times*, September 21, 1997, p. A4.
[7]S. Greenhouse, "Nike Shoe Plant in Vietnam Is Called Unsafe for Workers," *The New York Times*, November 8, 1997.
[8]Ibid.

NIKE'S RESPONSES

Unaccustomed to playing defense, over the years, Nike formulated a number of strategies and tactics to deal with the problems of working conditions and pay in subcontractors. In 1996, Nike hired onetime U.S. Ambassador to the United Nations, U.S. congressman, and former Atlanta Mayor Andrew Young to assess working conditions in subcontractors' plants around the world. Young released a mildly critical report of Nike in mid-1997. After completing a two-week tour that covered three countries and 15 factories, Young informed Nike it was doing a good job in treating workers, though it should do better. According to Young, he did not see:

> sweatshops, or hostile conditions . . . I saw crowded dorms . . . but the workers were eating at least two meals a day on the job and making what I was told were subsistence wages in those cultures.[9]

Young was widely criticized by human rights and labor groups for not taking his own translators and for doing slipshod inspections, an assertion he repeatedly denied.

In 1996, Nike joined a presidential task force designed to find a way of banishing sweatshops in the shoe and clothing industries. The task force included industry leaders such as Nike, representatives from human rights groups, and labor leaders. In April 1997, they announced an agreement for workers' rights that U.S. companies could agree to when manufacturing abroad. The accord limited the workweek to 60 hours and called for paying at least the local minimum wage in foreign factories. The task force also agreed to establish an independent monitoring association—later named the Fair Labor Association (FLA)—to assess whether companies are abiding by the code.[10]

The FLA now includes among its members the Lawyers Committee for Human Rights, the National Council of Churches, the International Labor Rights Fund, some 135 universities (universities have extensive licensing agreements with sports apparel companies such as Nike), and companies such as Nike, Reebok, and Levi Strauss.

In early 1997, Nike also began to commission independent organizations such as Ernst & Young to audit the factories of its subcontractors. In September 1997, Nike tried to show its critics that it was involved in more than just a public relations exercise when it terminated its relationship with four Indonesia subcontractors, stating they had refused to comply with the company's standard for wage levels and working conditions. Nike identified one of the subcontractors, Seyon, which manufactured specialty sports gloves for Nike. Nike said Seyon refused to meet a 10.7 percent increase in the monthly wage, to $70.30, declared by the Indonesian government in April 1997.[11]

On May 12, 1998, in a speech given at the National Press Club, Phil Knight spelled out in detail a series of initiatives designed to improve working conditions for the 500,000 people that make products for Nike at subcontractors.[12] Among the initiatives, Knight highlighted were the following:

> We have effectively changed our minimum age limits from the ILO (International Labor Organization) standards of 15 in most countries and 14 in developing countries to 18 in all footwear manufacturing and 16 in all other types of manufacturing (apparel, accessories, and equipment.). Existing workers legally employed under the former limits were grandfathered into the new requirements.
>
> During the past 13 months we have moved to a 100 percent factory audit scheme, where every Nike contract factory will receive an annual check by PricewaterhouseCoopers teams who are specially trained on our Code of Conduct Owner's Manual and audit/monitoring procedures. To date they have performed about 300 such monitoring visits. In a few instances in apparel factories they have found workers under our age standards. Those factories have been required to raise their standards to 17 years of age, to require three documents certifying age, and to redouble their efforts to ensure workers meet those standards through interviews and records checks.
>
> Our goal was to ensure workers around the globe are protected by requiring factories to have no workers exposed to levels above those mandated by the permissible exposure limits (PELs) for chemicals prescribed in the OSHA indoor air quality standards.[13]

These moves were applauded in the business press, but they were greeted with a skeptical response from Nike's long-term adversaries in the debate over the use of foreign labor. While conceding that's Nike's policies were an improvement, one critic writing in *The New York Times* noted:

> Mr. Knight's child labor initiative is . . . a smokescreen. Child labor has not been a big problem with Nike, and Philip Knight knows that better than anyone. But public relations is public relations. So he announces that he's not going to let the factories hire kids, and suddenly that's the headline.
>
> Mr. Knight is like a three-card monte player. You have to keep a close eye on him at all times.
>
> The biggest problem with Nike is that its overseas workers make wretched, below-subsistence wages. It's not the minimum age that needs raising; it's the

[9] Quoted in Dobnik, "Chinese Workers Abused Making Nikes, Reeboks."
[10] W. Bounds and H. Stout, "Sweatshop Pact: Good Fit or Threadbare?" *The Wall Street Journal*, April 10, 1997, p. A2.
[11] "Nike Gives Four Factories the Boot," *Los Angeles Times*, September 23, 1997, p. 20.
[12] Archived at www.nikebiz.com/labor/speech_trans.shtml.
[13] OSHA is the United States Occupational Safety and Health Agency.

minimum wage. Most of the workers in Nike factories in China and Vietnam make less than $2 a day, well below the subsistence levels in those countries. In Indonesia the pay is less than $1 a day.

The company's current strategy is to reshape its public image while doing as little as possible for the workers. Does anyone think it was an accident that Nike set up shop in human rights sinkholes, where labor organizing was viewed as a criminal activity and deeply impoverished workers were willing, even eager, to take their places on assembly lines and work for next to nothing?[14]

Other critics question the value of Nike's auditors, PricewaterhouseCoopers (PwC). Dara O'Rourke, an assistant professor at MIT, followed the PwC auditors around several factories in China, Korea, and Vietnam. He concluded that although the auditors found minor violations of labor laws and codes of conduct, they missed major labor practice issues including hazardous working conditions, violations of overtime laws, and violation of wage laws. The problem, according to O'Rourke, was that the auditors had limited training and relied on factory managers for data and to set up interviews with workers, all of which were performed in the factories. The auditors, in other words, were getting an incomplete and somewhat sanitized view of conditions in the factory.[15]

THE CONTROVERSY CONTINUES

Fueled perhaps by the unforgiving criticisms of Nike that continued after Phil Knight's May 1998 speech, beginning in 1998 and continuing into 2001, a wave of protests against Nike occurred on many university campuses. The moving force behind the protests was the United Students Against Sweatshops (USAS). The USAS argued that the Fair Labor Association (FLA), which grew out of the presidential task force on sweatshops, was an industry tool and not a truly independent auditor of foreign factories. The USAS set up an alternative independent auditing organization, the Workers Rights Consortium (WRC), which they charged with auditing factories that produce products under collegiate licensing programs (Nike is a high-profile supplier of products under these programs). The WRC is backed, and partly funded, by labor unions and refuses to cooperate with companies, arguing that doing so would jeopardize its independence.

By mid-2000, the WRC had persuaded some 48 universities to join the WRC, including all nine campuses of the University of California systems, the University of Michigan, and the University of Oregon, Phil Knights' alma mater. When Knight heard that the University of Oregon would join the WRC, as opposed to the FLA, he withdrew a planned $30 million donation to the university.[16] Despite this, in November 2000 another major northwestern university, the University of Washington, announced it too would join the WRC, although it would also retain its membership in the FLA.[17]

Nike continued to push forward with its own initiatives, updating progress on its website. In April 2000, in response to accusations that it was still hiding conditions, it announced it would release the complete reports of all independent audits of its subcontractors' plants. Global Exchange continued to criticize the company, arguing in mid-2001 that the company was not living up to Phil Knight's 1998 promises, and that it was intimidating workers from speaking out about abuses.[18]

Case Discussion Questions

1. Should Nike be held responsible for working conditions in foreign factories that it does not own, but where subcontractors make products for Nike?
2. What labor standards regarding safety, working conditions, overtime, and the like, should Nike hold foreign factories to: those prevailing in that country, or those prevailing in the United States?
3. An income of $2.28 a day, the base pay of Nike factory workers in Indonesia, is double the daily income of about half the working population. Half of all adults in Indonesia are farmers, who receive less than $1 a day. Given this, is it correct to criticize Nike for the low pay rates of its subcontractors in Indonesia?[19]
4. Could Nike have handled the negative publicity over sweatshops better? What might it have done differently, not just from a public relations perspective, but also from a policy perspective?
5. Do you think Nike needs to make any changes to its current policy? If so, what? Should Nike make changes even if they hinder the ability of the company to compete in the marketplace?
6. Is the WRC right to argue that the FLA is a tool of industry?
7. If sweatshops are a global problem, what might be a global solution to this problem?

[14] B. Herbet, "Nike Blinks," *The New York Times*, May 21, 1998.
[15] Dara O'Rourke, "Monitoring the Monitors: A Critique of the PricewaterhouseCoopers (PwC) Labor Monitoring," Department of Urban Studies and Planning, MIT.
[16] L. Lee and A. Bernstein, "Who Says Student Protests Don't Matter?" *BusinessWeek*, June 12, 2000, pp. 94–96.
[17] R. Deen, "UW to Join Anti-Sweatshop Group," *Seattle Post Intelligencer*, November 20, 2000, p. B2.
[18] "Rights Group Says Nike Isn't Fulfilling Promises," *The Wall Street Journal*, May 16, 2001.
[19] Figures from P. Kenel, "The Sweatshop Dilemma," *Christian Science Monitor*, August 21, 1996, p. 20.

Etch-A-Sketch Ethics

The Ohio Art Company is perhaps best known as the producer of one of the top-selling toys of all time, the venerable Etch-A-Sketch. More than 100 million of the familiar red rectangular drawing toys have been sold since 1960 when it was invented. The late 1990s, however, became a troubled time for the toy's maker. Confronted with sluggish toy sales, the Ohio Art Company lost money for two years. In December 2000, it made the strategic decision to outsource production of the Etch-A-Sketch toys to Kin Ki Industrial, a leading Chinese toymaker, laying off 100 U.S. workers in the process.

The closure of the Etch-A-Sketch line was not unexpected among employees. The company had already moved the production of other toy lines to China, and most employees knew it was just a matter of time before Etch-A-Sketch went too. Still, the decision was a tough one for the company, which did most of its manufacturing in its home base, the small Ohio town of Bryan (population 8,000). As William Killgallon, the CEO of the Ohio Art Company, noted, the employees who made the product "were like family. It was a necessary financial decision we saw coming for some time, and we did it gradually, product by product. But that doesn't mean it's emotionally easy."

In a small town such as Bryan, the cumulative effect of outsourcing to China has been significant. The tax base is eroding from a loss of manufacturing and a population decline. The local paper is full of notices of home foreclosures and auctions. According to former employees, the biggest hole in their lives after Etch-A-Sketch moved came from the death of a community. For many workers, the company was their family, and now that family was gone.

The rational for the outsourcing was simple enough. Pressured to keep the cost of Etch-A-Sketch under $10 by big retailers such as Walmart and Toys "R" Us, the Ohio Art Company had to get its costs down or lose money. In this case, unionized workers making $1,500 a month were replaced by Chinese factory workers who made $75 a month. However, according to Killgallon, the main savings came not from lower wages, but from lower overhead costs for plant, maintenance, electricity, and payroll, and the ability to get out from the soaring costs of providing health benefits to U.S. manufacturing employees.

The choice of Kin Ki as manufacturer for Etch-A-Sketch was easy—the company had been making pocket-sized Etch-A-Sketch toys for nearly a decade and always delivered on cost. To help Kin Ki, the Ohio Art Company shipped some of its best equipment to the company, and it continues to send crucial raw materials, such as aluminum powder, which is hard to get in China.

The story would have ended there had it not been for an exposé in *The New York Times* in December 2003. The *Times* reporter painted a dismal picture of working conditions at the Kin Ki factory that manufactured the Etch-A-Sketch. According to official Kin Ki publications:

> Workers at Kin Ki make a decent salary, rarely work nights or weekends, and often "hang out along the streets, playing Ping Pong and watching TV." They all have work contracts, pensions, and medical benefits. The factory canteen offers tasty food. The dormitories are comfortable.

Not so, according to Joseph Kahn, the *Times* reporter. He alleged that real-world Kin Ki employees, mostly teenage migrants from internal Chinese provinces, work long hours for 40 percent less than the company claims. They are paid 24 cents per hour, below the legal minimum wage of 33 cents an hour in Shenzhen province where Kin Ki is located. Most do not have pensions, medical benefits, or employment contracts. Production starts at 7:30 a.m. and continues until 10 p.m., with breaks only for lunch and dinner. Saturdays and Sundays are treated as normal workdays. This translates into a workweek of seven 12-hour days, or 84 hours a week, well above the standard 40-hour week set by authorities in Shenzhen. Local rules also allow for no more than 32 hours of overtime and stipulate that the employees must be paid 1.5 times the standard hourly wage, but Kin Ki's overtime rate is just 1.3 times base pay.

As for the "comfortable dormitories," the workers sleep head to toe in tiny rooms with windows that are covered with chicken wire. To get into and out of the factories, which are surrounded by high walls, workers must enter and leave through a guarded gate. As for the tasty food, it is apparently a mix of boiled vegetables, beans, and rice, with meat or fish served only twice a month.

The workers at Kin Ki have apparently become restless. They went on strike twice in 2003, demanding higher wages and better working conditions. The company responded by raising wages a few cents and allotting an extra dish of food to each worker per day (but still no more meat)! However, Kin Ki simultaneously made "fried squid" of two workers who were ringleaders of the strike ("fried squid" is apparently a popular term for dismissal). Johnson Tao, a senior executive at the company, denies that the two ringleaders were dismissed for organizing the strikes. Rather, he noted they were well-known troublemakers who left the factory of their own accord. Tao acknowledges the low wages at the company, stating, "I know that I need to increase wages to comply with the law. I have the intention of doing this and will raise all wages in 2004."

Meanwhile, in Ohio, William Killgallon, Ohio Art Company's CEO, stated to the *Times* reporter that he considered Kin Ki's executives to be honest and that he had no knowledge of labor problems there. But he said he intended to visit China soon to make sure "they understand what we expect."

Case Discussion Questions

1. Was it ethical of the Ohio Art Company to move production to China? What were the economic and social costs and benefits of this decision? What would have happened if production had not been moved?
2. Assuming that the description of working conditions given in *The New York Times* is correct, is it ethical for the Ohio Art Company to continue using Kin Ki to manufacture Etch-A-Sketch toys?
3. Is it possible, as Killgallon claims, that the Ohio Art Company had no knowledge of labor problems at Kin Ki? Do you think company executives had any knowledge of the working conditions?
4. What steps can executives at the Ohio Art Company take to make sure they do not find the company profiled in *The New York Times* again as an enterprise that benefits from sweatshop labor?

Sources

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part three The Global Trade and Investment Environment

6 International Trade Theory

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Understand why nations trade with each other.
- **LO2** Summarize the different theories explaining trade flows between nations.
- **LO3** Recognize why many economists believe that unrestricted free trade between nations will raise the economic welfare of countries that participate in a free trade system.
- **LO4** Explain the arguments of those who maintain that government can play a proactive role in promoting national competitive advantage in certain industries.
- **LO5** Understand the important implications that international trade theory holds for business practice.

The Rise of India's Drug Industry

One of the great success stories in international trade in recent years has been the strong growth of India's pharmaceutical industry. The country used to be known for producing cheap knockoffs of patented drugs discovered by Western and Japanese pharmaceutical companies. This made the industry something of an international pariah. Since they made copies of patented products, and therefore violated intellectual property rights, Indian companies were not allowed to sell these products in developed markets. With no assurance that their intellectual property would be protected, foreign drug companies refused to invest in, partner with, or buy from their Indian counterparts, further limiting the business opportunities of Indian companies. In developed markets such as the United States, the best that Indian companies could do was to sell low-cost generic pharmaceuticals (generic pharmaceuticals are products whose patent has expired).

In 2005, however, India signed an agreement with the World Trade Organization that bought the country into compliance with WTO rules on intellectual property rights. Indian companies stopped producing counterfeit products. Now that their patents would be respected, foreign companies started to do business with their Indian counterparts. For India, the result has been dramatic growth in its pharmaceutical sector. The sector generated sales of close to $24 billion in 2010, more than double the figure of 2005. Driving this growth have been surging exports. In 2000 pharmaceutical exports from India amounted to about $1 billion. By 2010, the figure was nearing $10 billion.

Much of this growth has been the result of partnerships between Western and Indian firms. Western companies have been increasingly outsourcing manufacturing and packaging activities to India, while at the same time scaling back some of these activities at home and in places such as Puerto Rico, which historically has been a major manufacturing hub for firms serving the U.S. market. India's advantages in manufacturing and packaging include relatively low wage rates, an educated workforce, and the widespread use of English as a business language. Western companies have continued to perform



high value-added R&D, marketing, and sales activities, and these remain located in their home markets.

During India's years as an international pariah in the drug business, its nascent domestic industry set the foundations for today's growth. Local start-ups invested in the facilities required to discover and produce pharmaceuticals, creating a market for pharmaceutical scientists and workers in India. In turn, this drove the expansion of pharmaceutical programs in the country's universities, thereby increasing the supply of talent. Moreover, the industry's experience in the generic drug business during the 1990s and early 2000s gained it expertise in dealing with regulatory agencies in the United States and European Union. After 2005, this know-how made Indian companies more attractive as partners for Western enterprises. Combined with low labor costs, all these factors came together to make India an increasingly attractive location for the manufacturing of pharmaceuticals.

The U.S. Federal Drug Administration (FDA) responded to the shift of manufacturing to India by opening two offices there to oversee manufacturing compliance and make sure safety was consistent with FDA-mandated standards. Today the FDA has issued approvals to producing pharmaceuticals for sale in the United States to some 900 plants in India, giving Indian companies a legitimacy that potential rivals in places such as China lack.

For Western enterprises, the obvious attraction of outsourcing drug manufacturing to India is that it lowers their costs, enabling them to protect their earnings in an increasingly difficult domestic environment where government health care regulation and increased competition have put pressure on the pricing of many pharmaceuticals. Arguably, this also benefits consumers in the United States because lower pharmaceutical prices mean lower insurance costs, smaller co-pays, and ultimately lower out-of-pocket expenses than if those pharmaceuticals were still manufactured domestically. Offset against this economic benefit, of course, must be the cost of jobs lost in U.S. pharmaceutical manufacturing. Indicative of this trend, total manufacturing employment in this sector fell by 5 percent between 2008 and 2010.[1]

Introduction

The growth of the Indian pharmaceutical industry is an example of the benefits of free trade and globalization. Before 2005 Indian pharmaceutical companies were shut out of many developed markets by legal barriers to trade. The fact that India did not respect drug patents, and allowed domestic companies to make counterfeit versions of patented medicines, meant that Indian companies were prohibited from selling these products in developed nations. In 2005 India signed an agreement that brought it into compliance with global patent rules. Indian companies stopped making counterfeit medicines, so they could now trade freely with developed countries. This opened up a host of legitimate business opportunities. Today, the fast-growing Indian pharmaceutical industry manufactures low-cost generic and patented medicines for sale around the world, often in partnership with Western drug companies. Western companies continue to perform R&D and marketing activities at home, while contracting out some of their manufacturing activities to Indian enterprises. This practice has lowered manufacturing costs for Western companies and, in turn, led to lower prices and lower insurance costs for Western consumers. At the same time it has helped created jobs and wealth in India, enabling Indians to boost their purchases of goods and services produced by Western nations.

If there are losers in this process, it is in manufacturing employees in the pharmaceutical industry in developed markets such as the United States, where the number of jobs is starting to fall. In the world of international trade, there are always winners and losers, but as economists have long argued, the benefits to the winners outweigh the costs borne by the losers, resulting in a net gain to society. Moreover, economists argue that in the long-run, free trade stimulates economic growth and raises living standards across the board. For example, as India gets richer, the nation's citizens will consume more goods and services produced in the United States, raising U.S. living standards. On balance, free trade, in the view of economists, is a win–win situation.

The economic arguments surrounding the benefits and costs of free trade in goods and services are not abstract academic ones. International trade theory has shaped the economic policy of many nations for the past 50 years. It was the driver behind the formation of the World Trade Organization and regional trade blocs such as the European Union and the North American Free Trade Agreement (NAFTA). The 1990s, in particular, saw a global move toward greater free trade. It is crucially important to understand, therefore, what these theories are and why they have been so successful in shaping the economic policy of so many nations and the competitive environment in which international businesses compete.

This chapter has two goals that go to the heart of the debate over the benefits and costs of free trade. The first is to review a number of theories that explain why it is beneficial for a country to engage in international trade. The second goal is to explain the pattern of international trade that we observe in the world economy. With regard to the pattern of trade, we will be primarily concerned with explaining the pattern of exports and imports of goods and services between countries. The pattern of foreign direct investment between countries is discussed in Chapter 8.

An Overview of Trade Theory

We open this chapter with a discussion of mercantilism. Propagated in the sixteenth and seventeenth centuries, mercantilism advocated that countries should simultaneously encourage exports and discourage imports. Although mercantilism is an old and largely discredited doctrine, its echoes remain in modern political debate and in the trade policies of many countries. Next, we will look at Adam Smith's theory of absolute advantage. Proposed in 1776, Smith's theory was the first to explain why unrestricted free trade is beneficial to a country. **Free trade** refers to a situation where a government does not attempt to influence through quotas or duties what its citizens can buy from another

country, or what they can produce and sell to another country. Smith argued that the invisible hand of the market mechanism, rather than government policy, should determine what a country imports and what it exports. His arguments imply that such a laissez-faire stance toward trade was in the best interests of a country. Building on Smith's work are two additional theories that we shall review. One is the theory of comparative advantage, advanced by the nineteenth-century English economist David Ricardo. This theory is the intellectual basis of the modern argument for unrestricted free trade. In the twentieth century, Ricardo's work was refined by two Swedish economists, Eli Heckscher and Bertil Ohlin, whose theory is known as the Heckscher-Ohlin theory.

THE BENEFITS OF TRADE

LO1

The great strength of the theories of Smith, Ricardo, and Heckscher-Ohlin is that they identify with precision the specific benefits of international trade. Common sense suggests that some international trade is beneficial. For example, nobody would suggest that Iceland should grow its own oranges. Iceland can benefit from trade by exchanging some of the products that it can produce at a low cost (fish) for some products that it cannot produce at all (oranges). Thus, by engaging in international trade, Icelanders are able to add oranges to their diet of fish.

The theories of Smith, Ricardo, and Heckscher-Ohlin go beyond this commonsense notion, however, to show why it is beneficial for a country to engage in international trade *even for products it is able to produce for itself*. This is a difficult concept for people to grasp. For example, many people in the United States believe that American consumers should buy products made in the United States by American companies whenever possible to help save American jobs from foreign competition. The same kind of nationalistic sentiments can be observed in many other countries.

However, the theories of Smith, Ricardo, and Heckscher-Ohlin tell us that a country's economy may gain if its citizens buy certain products from other nations that could be produced at home. The gains arise because international trade allows a country to *specialize* in the manufacture and export of products that can be produced most efficiently in that country, while importing products that can be produced more efficiently in other countries. Thus it may make sense for the United States to specialize in the production and export of commercial jet aircraft, since the efficient production of commercial jet aircraft requires resources that are abundant in the United States, such as a highly skilled labor force and cutting-edge technological know-how. On the other hand, it may make sense for the United States to import textiles from Bangladesh since the efficient production of textiles requires a relatively cheap labor force—and cheap labor is not abundant in the United States.

Of course, this economic argument is often difficult for segments of a country's population to accept. With their future threatened by imports, U.S. textile companies and their employees have tried hard to persuade the government to limit the importation of textiles by demanding quotas and tariffs. Although such import controls may benefit particular groups, such as textile businesses and their employees, the theories of Smith, Ricardo, and Heckscher-Ohlin suggest that the economy as a whole is hurt by such action. One of the key insights of international trade theory is that limits on imports are often in the interests of domestic producers, but not domestic consumers.

THE PATTERN OF INTERNATIONAL TRADE

The theories of Smith, Ricardo, and Heckscher-Ohlin help to explain the pattern of international trade that we observe in the world economy. Some aspects of the pattern are easy to understand. Climate and natural resource endowments explain why Ghana exports cocoa, Brazil exports coffee, Saudi Arabia exports oil, and China exports crawfish. However, much of the observed pattern of international trade is more difficult to explain. For example, why does Japan export automobiles, consumer electronics, and machine

tools? Why does Switzerland export chemicals, pharmaceuticals, watches, and jewelry? Why does Bangladesh export garments? David Ricardo's theory of comparative advantage offers an explanation in terms of international differences in labor productivity. The more sophisticated Heckscher-Ohlin theory emphasizes the interplay between the proportions in which the factors of production (such as land, labor, and capital) are available in different countries and the proportions in which they are needed for producing particular goods. This explanation rests on the assumption that countries have varying endowments of the various factors of production. Tests of this theory, however, suggest that it is a less powerful explanation of real-world trade patterns than once thought.

One early response to the failure of the Heckscher-Ohlin theory to explain the observed pattern of international trade was the product life-cycle theory. Proposed by Raymond Vernon, this theory suggests that early in their life cycle, most new products are produced in and exported from the country in which they were developed. As a new product becomes widely accepted internationally, however, production starts in other countries. As a result, the theory suggests, the product may ultimately be exported back to the country of its original innovation.

In a similar vein, during the 1980s economists such as Nobel Prize winner Paul Krugman developed what has come to be known as the new trade theory. **New trade theory** (for which Krugman won the Nobel Prize in 2008) stresses that in some cases countries specialize in the production and export of particular products not because of underlying differences in factor endowments, but because in certain industries the world market can support only a limited number of firms. (This is argued to be the case for the commercial aircraft industry.) In such industries, firms that enter the market first are able to build a competitive advantage that is subsequently difficult to challenge. Thus, the observed pattern of trade between nations may be due in part to the ability of firms within a given nation to capture first-mover advantages. The United States is a major exporter of commercial jet aircraft because American firms such as Boeing were first movers in the world market. Boeing built a competitive advantage that has subsequently been difficult for firms from countries with equally favorable factor endowments to challenge (although Europe's Airbus Industrie has succeeded in doing that). In a work related to the new trade theory, Michael Porter developed a theory referred to as the theory of national competitive advantage. This attempts to explain why particular nations achieve international success in particular industries. In addition to factor endowments, Porter points out the importance of country factors such as domestic demand and domestic rivalry in explaining a nation's dominance in the production and export of particular products.

TRADE THEORY AND GOVERNMENT POLICY

Although all these theories agree that international trade is beneficial to a country, they lack agreement in their recommendations for government policy. Mercantilism makes a crude case for government involvement in promoting exports and limiting imports. The theories of Smith, Ricardo, and Heckscher-Ohlin form part of the case for unrestricted free trade. The argument for unrestricted free trade is that both import controls and export incentives (such as subsidies) are self-defeating and result in wasted resources. Both the new trade theory and Porter's theory of national competitive advantage can be interpreted as justifying some limited government intervention to support the development of certain export-oriented industries. We will discuss the pros and cons of this argument, known as strategic trade policy, as well as the pros and cons of the argument for unrestricted free trade, in Chapter 7.

LO2 Mercantilism

The first theory of international trade, mercantilism, emerged in England in the mid-sixteenth century. The principle assertion of mercantilism was that gold and silver were the mainstays of national wealth and essential to vigorous commerce. At that time, gold

and silver were the currency of trade between countries; a country could earn gold and silver by exporting goods. Conversely, importing goods from other countries would result in an outflow of gold and silver to those countries. The main tenet of **mercantilism** was that it was in a country's best interests to maintain a trade surplus, to export more than it imported. By doing so, a country would accumulate gold and silver and, consequently, increase its national wealth, prestige, and power. As the English mercantilist writer Thomas Mun put it in 1630:

> The ordinary means therefore to increase our wealth and treasure is by foreign trade, wherein we must ever observe this rule: to sell more to strangers yearly than we consume of theirs in value.[2]

Consistent with this belief, the mercantilist doctrine advocated government intervention to achieve a surplus in the balance of trade. The mercantilists saw no virtue in a large volume of trade. Rather, they recommended policies to maximize exports and minimize imports. To achieve this, imports were limited by tariffs and quotas, while exports were subsidized.

The classical economist David Hume pointed out an inherent inconsistency in the mercantilist doctrine in 1752. According to Hume, if England had a balance-of-trade surplus with France (it exported more than it imported) the resulting inflow of gold and silver would swell the domestic money supply and generate inflation in England. In France, however, the outflow of gold and silver would have the opposite effect. France's money supply would contract, and its prices would fall. This change in relative prices between France and England would encourage the French to buy fewer English goods (because they were becoming more expensive) and the English to buy more French goods (because they were becoming cheaper). The result would be a deterioration in the English balance of trade and an improvement in France's trade balance, until the English surplus was eliminated. Hence, according to Hume, in the long run no country could sustain a surplus on the balance of trade and so accumulate gold and silver as the mercantilists had envisaged.

The flaw with mercantilism was that it viewed trade as a zero-sum game. (A **zero-sum game** is one in which a gain by one country results in a loss by another.) It was left to Adam Smith and David Ricardo to show the shortsightedness of this approach and to demonstrate that trade is a positive-sum game, or a situation in which all countries can benefit. Unfortunately, the mercantilist doctrine is by no means dead. Neo-mercantilists equate political power with economic power and economic power with a balance-of-trade surplus. Critics argue that many nations have adopted a neo-mercantilist strategy that is designed to simultaneously boost exports and limit imports.[3] For example, critics charge that China is pursuing a neo-mercantilist policy, deliberately keeping its currency value low against the U.S. dollar in order to sell more goods to the United States and other developed nations, and thus amass a trade surplus and foreign exchange reserves (see the accompanying Country Focus).

Absolute Advantage

LO2

In his 1776 landmark book *The Wealth of Nations*, Adam Smith attacked the mercantilist assumption that trade is a zero-sum game. Smith argued that countries differ in their ability to produce goods efficiently. In his time, the English, by virtue of their superior manufacturing processes, were the world's most efficient textile manufacturers. Due to the combination of favorable climate, good soils, and accumulated expertise, the French had the world's most efficient wine industry. The English had an *absolute advantage* in the production of textiles, while the French had an *absolute advantage* in the production of wine. Thus, a country has an **absolute advantage** in the production of a product when it is more efficient than any other country in producing it.

According to Smith, countries should specialize in the production of goods for which they have an absolute advantage and then trade these for goods produced by

COUNTRY FOCUS

Is China a Neo-Mercantilist Nation?

China's rapid rise in economic power (it is now the world's second-largest economy) has been built on export-led growth. The country takes raw material imports and, using its cheap labor, converts them into products that it sells to developed nations. For years, the country's exports have been growing faster than its imports, leading some critics to claim that China is pursuing a neo-mercantilist policy, trying to amass record trade surpluses and foreign currency that will give it economic power over developed nations. This rhetoric reached new heights in 2008 when China's trade surplus hit a record $280 billion and its foreign exchange reserves exceeded $1.95 trillion, some 70 percent of which are held in U.S. dollars. Observers worry that if China ever decides to sell its holdings of U.S. currency, this could depress the value of the dollar against other currencies and increase the price of imports into America.

Throughout 2005–2008, China's exports grew much faster than its imports, leading some to argue that China was limiting imports by pursuing an import substitution policy, encouraging domestic investment in the production of products such as steel, aluminum, and paper, which it had historically imported from other nations. The trade deficit with America has been a particular cause for concern. In 2008, this reached $260 billion, the largest deficit ever recorded with a single country. At the same time, China has long resisted attempts to let its currency float freely against the U.S. dollar. Many claim that China's currency is too cheap, and that this keeps the prices of China's goods artificially low, which fuels the country's exports.

So is China a neo-mercantilist nation that is deliberately discouraging imports and encouraging exports in order to grow its trade surplus and accumulate foreign exchange reserves, which might give it economic power? The jury is out on this issue. Skeptics suggest that going forward the country will have no choice but to increase its imports of commodities that it lacks, such as oil. They also note that China did start allowing the value of the renminbi (China's currency) to appreciate against the dollar in July 2005. Between then and December 2009, it appreciated 17 percent in value. The Chinese allowed their currency to appreciate another 3 percent against the U.S. dollar during 2010. In response, China's trade surplus has started to contract as export growth has slowed and imports have increased. In 2010 the surplus was $183 billion, down substantially from the $280 billion in 2008. While this suggests that China's trade surplus may have peaked, the surplus is still significant.[4]

other countries. In Smith's time, this suggested the English should specialize in the production of textiles while the French should specialize in the production of wine. England could get all the wine it needed by selling its textiles to France and buying wine in exchange. Similarly, France could get all the textiles it needed by selling wine to England and buying textiles in exchange. Smith's basic argument, therefore, is that a country should never produce goods at home that it can buy at a lower cost from other countries. Smith demonstrates that, by specializing in the production of goods in which each has an absolute advantage, both countries benefit by engaging in trade.

Consider the effects of trade between two countries, Ghana and South Korea. The production of any good (output) requires resources (inputs) such as land, labor, and capital. Assume that Ghana and South Korea both have the same amount of resources and that these resources can be used to produce either rice or cocoa. Assume further that 200 units of resources are available in each country. Imagine that in Ghana it takes 10 resources to produce one ton of cocoa and 20 resources to produce one ton of rice. Thus, Ghana could produce 20 tons of cocoa and no rice, 10 tons of rice and no cocoa, or some combination of rice and cocoa between these two extremes. The different combinations that Ghana could produce are represented by the line GG′

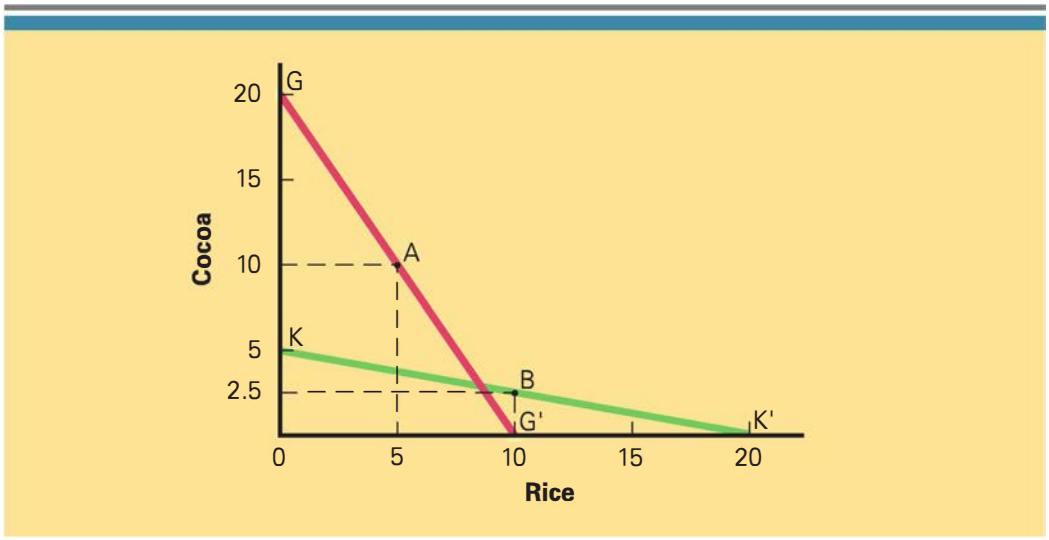


FIGURE 6.1

The Theory of Absolute Advantage

in Figure 6.1. This is referred to as Ghana's *production possibility frontier* (PPF). Similarly, imagine that in South Korea it takes 40 resources to produce one ton of cocoa and 10 resources to produce one ton of rice. Thus, South Korea could produce 5 tons of cocoa and no rice, 20 tons of rice and no cocoa, or some combination between these two extremes. The different combinations available to South Korea are represented by the line KK′ in Figure 6.1, which is South Korea's PPF. Clearly, Ghana has an absolute advantage in the production of cocoa. (More resources are needed to produce a ton of cocoa in South Korea than in Ghana.) By the same token, South Korea has an absolute advantage in the production of rice.

Now consider a situation in which neither country trades with any other. Each country devotes half of its resources to the production of rice and half to the production of cocoa. Each country must also consume what it produces. Ghana would be able to produce 10 tons of cocoa and 5 tons of rice (point A in Figure 6.1), while South Korea would be able to produce 10 tons of rice and 2.5 tons of cocoa. Without trade, the combined production of both countries would be 12.5 tons of cocoa (10 tons in Ghana plus 2.5 tons in South Korea) and 15 tons of rice (5 tons in Ghana and 10 tons in South Korea). If each country were to specialize in producing the good for which it had an absolute advantage and then trade with the other for the good it lacks, Ghana could produce 20 tons of cocoa, and South Korea could produce 20 tons of rice. Thus, by specializing, the production of both goods could be increased. Production of cocoa would increase from 12.5 tons to 20 tons, while production of rice would increase from 15 tons to 20 tons. The increase in production that would result from specialization is therefore 7.5 tons of cocoa and 5 tons of rice. Table 6.1 summarizes these figures.

By engaging in trade and swapping one ton of cocoa for one ton of rice, producers in both countries could consume more of both cocoa and rice. Imagine that Ghana and South Korea swap cocoa and rice on a one-to-one basis; that is, the price of one ton of cocoa is equal to the price of one ton of rice. If Ghana decided to export 6 tons of cocoa to South Korea and import 6 tons of rice in return, its final consumption after trade would be 14 tons of cocoa and 6 tons of rice. This is 4 tons more cocoa than it could have consumed before specialization and trade and 1 ton more rice. Similarly, South Korea's final consumption after trade would be 6 tons of cocoa and 14 tons of rice. This is 3.5 tons more cocoa than it could have consumed before specialization and trade and 4 tons more rice. Thus, as a result of specialization and trade, output of both cocoa and rice would be increased, and consumers in both nations would be able to consume more. Thus, we can see that trade is a positive-sum game; it produces net gains for all involved.

TABLE 6.1

Absolute Advantage and the Gains from Trade

Resources Required to Produce 1 Ton of Cocoa and Rice		
	Cocoa	**Rice**
Ghana	10	20
South Korea	40	10
Production and Consumption without Trade		
	Cocoa	**Rice**
Ghana	10.0	5.0
South Korea	2.5	10.0
Total production	12.5	15.0
Production with Specialization		
	Cocoa	**Rice**
Ghana	20.0	0.0
South Korea	0.0	20.0
Total production	20.0	20.0
Consumption After Ghana Trades 6 Tons of Cocoa for 6 Tons of South Korean Rice		
	Cocoa	**Rice**
Ghana	14.0	6.0
South Korea	6.0	14.0
Increase in Consumption as a Result of Specialization and Trade		
	Cocoa	**Rice**
Ghana	4.0	1.0
South Korea	3.5	4.0

LO2 Comparative Advantage

David Ricardo took Adam Smith's theory one step further by exploring what might happen when one country has an absolute advantage in the production of all goods.[5] Smith's theory of absolute advantage suggests that such a country might derive no benefits from international trade. In his 1817 book *Principles of Political Economy*, Ricardo showed that this was not the case. According to Ricardo's theory of comparative advantage, it makes sense for a country to specialize in the production of those goods that it produces most efficiently and to buy the goods that it produces less efficiently from other countries, even if this means buying goods from other countries that it could produce more efficiently itself.[6] While this may seem counterintuitive, the logic can be explained with a simple example.

Assume that Ghana is more efficient in the production of both cocoa and rice; that is, Ghana has an absolute advantage in the production of both products. In Ghana it takes 10 resources to produce one ton of cocoa and $13\frac{1}{3}$ resources to produce one ton of rice. Thus, given its 200 units of resources, Ghana can produce 20 tons of cocoa and no rice, 15 tons of rice and no cocoa, or any combination in between on its PPF (the line GG′ in Figure 6.2). In South Korea it takes 40 resources to produce one ton of cocoa and 20 resources to produce one ton of rice. Thus, South Korea can produce 5 tons of cocoa and no rice, 10 tons of rice and no cocoa, or any combination on its PPF (the line KK′ in

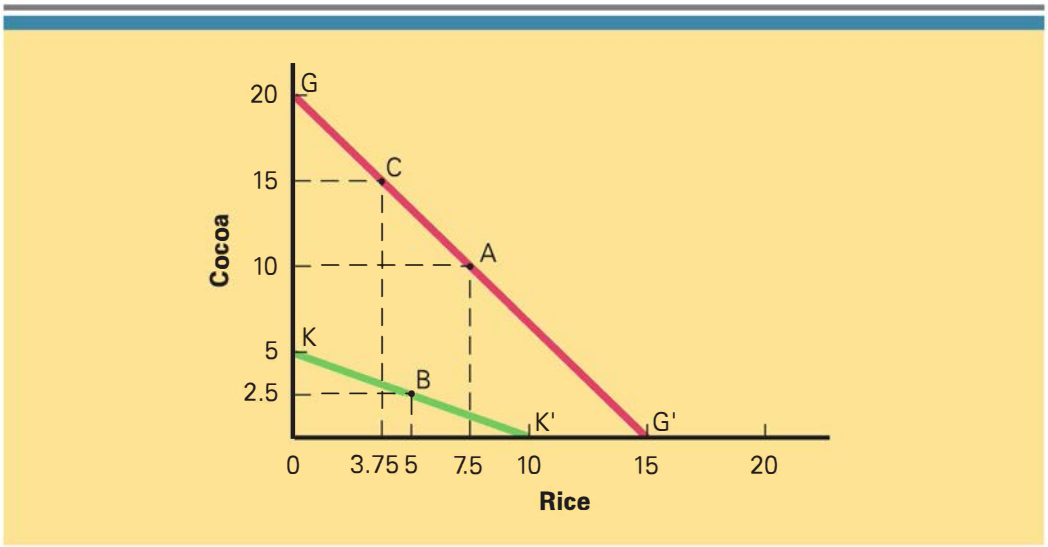


FIGURE 6.2

The Theory of Comparative Advantage

Figure 6.2). Again assume that without trade, each country uses half of its resources to produce rice and half to produce cocoa. Thus, without trade, Ghana will produce 10 tons of cocoa and 7.5 tons of rice (point A in Figure 6.2), while South Korea will produce 2.5 tons of cocoa and 5 tons of rice (point B in Figure 6.2).

In light of Ghana's absolute advantage in the production of both goods, why should it trade with South Korea? Although Ghana has an absolute advantage in the production of both cocoa and rice, it has a comparative advantage only in the production of cocoa: Ghana can produce 4 times as much cocoa as South Korea, but only 1.5 times as much rice. Ghana is *comparatively* more efficient at producing cocoa than it is at producing rice.

Without trade the combined production of cocoa will be 12.5 tons (10 tons in Ghana and 2.5 in South Korea), and the combined production of rice will also be 12.5 tons (7.5 tons in Ghana and 5 tons in South Korea). Without trade each country must consume what it produces. By engaging in trade, the two countries can increase their combined production of rice and cocoa, and consumers in both nations can consume more of both goods.

THE GAINS FROM TRADE

Imagine that Ghana exploits its comparative advantage in the production of cocoa to increase its output from 10 tons to 15 tons. This uses up 150 units of resources, leaving the remaining 50 units of resources to use in producing 3.75 tons of rice (point C in Figure 6.2). Meanwhile, South Korea specializes in the production of rice, producing 10 tons. The combined output of both cocoa and rice has now increased. Before specialization, the combined output was 12.5 tons of cocoa and 12.5 tons of rice. Now it is 15 tons of cocoa and 13.75 tons of rice (3.75 tons in Ghana and 10 tons in South Korea). The source of the increase in production is summarized in Table 6.2.

Not only is output higher, but both countries also can now benefit from trade. If Ghana and South Korea swap cocoa and rice on a one-to-one basis, with both countries choosing to exchange 4 tons of their export for 4 tons of the import, both countries are able to consume more cocoa and rice than they could before specialization and trade (see Table 6.2). Thus, if Ghana exchanges 4 tons of cocoa with South Korea for 4 tons of rice, it is still left with 11 tons of cocoa, which is 1 ton more than it had before trade. The 4 tons of rice it gets from South Korea in exchange for its 4 tons of cocoa, when added to the 3.75 tons it now produces domestically, leaves it with a total of 7.75 tons of rice, which is .25 of a ton more than it had before specialization. Similarly, after swapping 4 tons of rice with Ghana, South Korea still ends up with 6 tons of rice, which is more than it had before specialization. In addition, the 4 tons of cocoa it receives in exchange is 1.5 tons more than it produced before trade. Thus, consumption of cocoa and rice can increase in both countries as a result of specialization and trade.

TABLE 6.2

Comparative Advantage and the Gains from Trade

Resources Required to Produce 1 Ton of Cocoa and Rice		
	Cocoa	**Rice**
Ghana	10	13.33
South Korea	40	20
Production and Consumption without Trade		
	Cocoa	**Rice**
Ghana	10.0	7.5
South Korea	2.5	5.0
Total production	12.5	12.5
Production with Specialization		
	Cocoa	**Rice**
Ghana	15.0	3.75
South Korea	0.0	10.0
Total production	15.0	13.75
Consumption After Ghana Trades 6 Tons of Cocoa for 6 Tons of South Korean Rice		
	Cocoa	**Rice**
Ghana	11.0	7.75
South Korea	4.0	6.0
Increase in Consumption as a Result of Specialization and Trade		
	Cocoa	**Rice**
Ghana	1.0	0.25
South Korea	1.5	1.0

The basic message of the theory of comparative advantage is that *potential world production is greater with unrestricted free trade than it is with restricted trade*. Ricardo's theory suggests that consumers in all nations can consume more if there are no restrictions on trade. This occurs even in countries that lack an absolute advantage in the production of any good. In other words, to an even greater degree than the theory of absolute advantage, *the theory of comparative advantage suggests that trade is a positive-sum game in which all countries that participate realize economic gains*. As such, this theory provides a strong rationale for encouraging free trade. So powerful is Ricardo's theory that it remains a major intellectual weapon for those who argue for free trade.

LO3 QUALIFICATIONS AND ASSUMPTIONS

The conclusion that free trade is universally beneficial is a rather bold one to draw from such a simple model. Our simple model includes many unrealistic assumptions:

1. We have assumed a simple world in which there are only two countries and two goods. In the real world, there are many countries and many goods.
2. We have assumed away transportation costs between countries.
3. We have assumed away differences in the prices of resources in different countries. We have said nothing about exchange rates, simply assuming that cocoa and rice could be swapped on a one-to-one basis.
4. We have assumed that resources can move freely from the production of one good to another within a country. In reality, this is not always the case.

5. We have assumed constant returns to scale, that is, that specialization by Ghana or South Korea has no effect on the amount of resources required to produce one ton of cocoa or rice. In reality, both diminishing and increasing returns to specialization exist. The amount of resources required to produce a good might decrease or increase as a nation specializes in production of that good.
6. We have assumed that each country has a fixed stock of resources and that free trade does not change the efficiency with which a country uses its resources. This static assumption makes no allowances for the dynamic changes in a country's stock of resources and in the efficiency with which the country uses its resources that might result from free trade.
7. We have assumed away the effects of trade on income distribution within a country.

Given these assumptions, can the conclusion that free trade is mutually beneficial be extended to the real world of many countries, many goods, positive transportation costs, volatile exchange rates, immobile domestic resources, nonconstant returns to specialization, and dynamic changes? Although a detailed extension of the theory of comparative advantage is beyond the scope of this book, economists have shown that the basic result derived from our simple model can be generalized to a world composed of many countries producing many different goods.[7] Despite the shortcomings of the Ricardian model, research suggests that the basic proposition that countries will export the goods that they are most efficient at producing is borne out by the data.[8]

However, once all the assumptions are dropped, the case for unrestricted free trade, while still positive, has been argued by some economists associated with the "new trade theory" to lose some of its strength.[9] We return to this issue later in this chapter and in the next when we discuss the new trade theory. In a recent and widely discussed analysis, the Nobel Prize-winning economist Paul Samuelson argued that contrary to the standard interpretation, in certain circumstances the theory of comparative advantage predicts that a rich country might actually be *worse* off by switching to a free trade regime with a poor nation.[10] We will consider Samuelson's critique in the next section.

EXTENSIONS OF THE RICARDIAN MODEL

Let us explore the effect of relaxing three of the assumptions identified above in the simple comparative advantage model. Below we relax the assumptions that resources move freely from the production of one good to another within a country, that there are constant returns to scale, and that trade does not change a country's stock of resources or the efficiency with which those resources are utilized.

Immobile Resources

In our simple comparative model of Ghana and South Korea, we assumed that producers (farmers) could easily convert land from the production of cocoa to rice, and vice versa. While this assumption may hold for some agricultural products, resources do not always shift quite so easily from producing one good to another. A certain amount of friction is involved. For example, embracing a free trade regime for an advanced economy such as the United States often implies that the country will produce less of some labor-intensive goods, such as textiles, and more of some knowledge-intensive goods, such as computer software or biotechnology products. Although the country as a whole will gain from such a shift, textile producers will lose. A textile worker in South Carolina is probably not qualified to write software for Microsoft. Thus, the shift to free trade may mean that she becomes unemployed or has to accept another less attractive job, such as working at a fast-food restaurant.

Resources do not always move easily from one economic activity to another. The process creates friction and human suffering too. While the theory predicts that the benefits of free trade outweigh the costs by a significant margin, this is of cold comfort to

those who bear the costs. Accordingly, political opposition to the adoption of a free trade regime typically comes from those whose jobs are most at risk. In the United States, for example, textile workers and their unions have long opposed the move toward free trade precisely because this group has much to lose from free trade. Governments often ease the transition toward free trade by helping to retrain those who lose their jobs as a result. The pain caused by the movement toward a free trade regime is a short-term phenomenon, while the gains from trade once the transition has been made are both significant and enduring.

Diminishing Returns

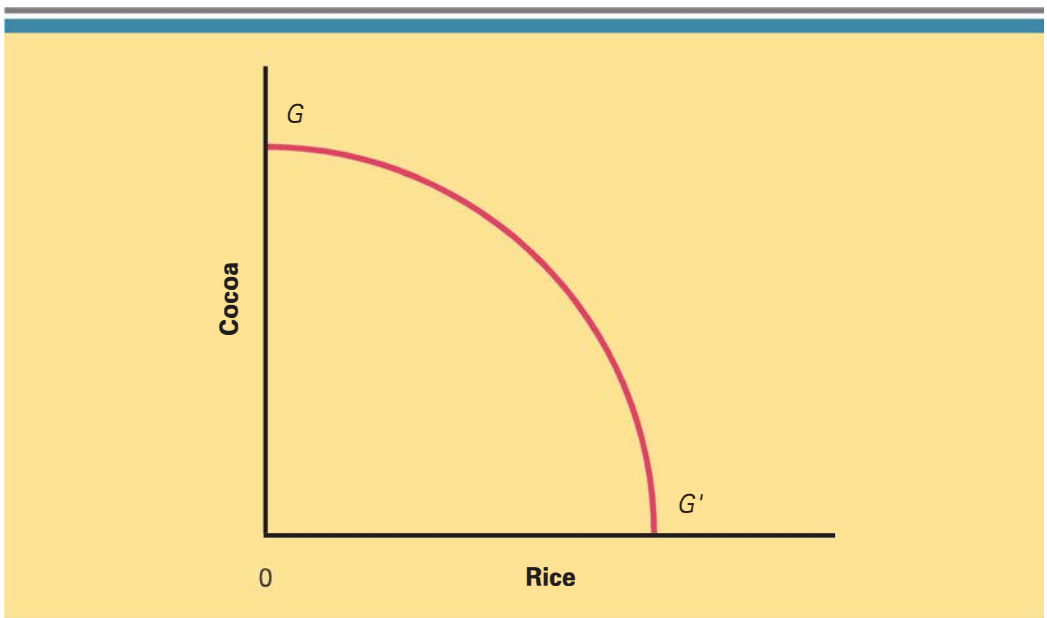
The simple comparative advantage model developed above assumes constant returns to specialization. By **constant returns to specialization** we mean the units of resources required to produce a good (cocoa or rice) are assumed to remain constant no matter where one is on a country's production possibility frontier (PPF). Thus, we assumed that it always took Ghana 10 units of resources to produce one ton of cocoa. However, it is more realistic to assume diminishing returns to specialization. Diminishing returns to specialization occurs when more units of resources are required to produce each additional unit. While 10 units of resources may be sufficient to increase Ghana's output of cocoa from 12 tons to 13 tons, 11 units of resources may be needed to increase output from 13 to 14 tons, 12 units of resources to increase output from 14 tons to 15 tons, and so on. Diminishing returns implies a convex PPF for Ghana (see Figure 6.3), rather than the straight line depicted in Figure 6.2.

It is more realistic to assume diminishing returns for two reasons. First, not all resources are of the same quality. As a country tries to increase its output of a certain good, it is increasingly likely to draw on more marginal resources whose productivity is not as great as those initially employed. The result is that it requires ever more resources to produce an equal increase in output. For example, some land is more productive than other land. As Ghana tries to expand its output of cocoa, it might have to utilize increasingly marginal land that is less fertile than the land it originally used. As yields per acre decline, Ghana must use more land to produce one ton of cocoa.

A second reason for diminishing returns is that different goods use resources in different proportions. For example, imagine that growing cocoa uses more land and less labor than growing rice, and that Ghana tries to transfer resources from rice production to cocoa production. The rice industry will release proportionately too much labor and too

FIGURE 6.3

Ghana's PPF Under Diminishing Returns



little land for efficient cocoa production. To absorb the additional resources of labor and land, the cocoa industry will have to shift toward more labor-intensive methods of production. The effect is that the efficiency with which the cocoa industry uses labor will decline, and returns will diminish.

Diminishing returns show that it is not feasible for a country to specialize to the degree suggested by the simple Ricardian model outlined earlier. Diminishing returns to specialization suggest that the gains from specialization are likely to be exhausted before specialization is complete. In reality, most countries do not specialize, but instead produce a range of goods. However, the theory predicts that it is worthwhile to specialize until that point where the resulting gains from trade are outweighed by diminishing returns. Thus, the basic conclusion that unrestricted free trade is beneficial still holds, although because of diminishing returns, the gains may not be as great as suggested in the constant returns case.

Dynamic Effects and Economic Growth

LO3

The simple comparative advantage model assumed that trade does not change a country's stock of resources or the efficiency with which it utilizes those resources. This static assumption makes no allowances for the dynamic changes that might result from trade. If we relax this assumption, it becomes apparent that opening an economy to trade is likely to generate dynamic gains of two sorts.[11] First, free trade might increase a country's stock of resources as increased supplies of labor and capital from abroad become available for use within the country. For example, this has been occurring in Eastern Europe since the early 1990s, with many Western businesses investing significant capital in the former Communist countries.

Second, free trade might also increase the efficiency with which a country uses its resources. Gains in the efficiency of resource utilization could arise from a number of factors. For example, economies of large-scale production might become available as trade expands the size of the total market available to domestic firms. Trade might make better technology from abroad available to domestic firms; better technology can increase labor productivity or the productivity of land. (The so-called green revolution had this effect on agricultural outputs in developing countries.) Also, opening an economy to foreign competition might stimulate domestic producers to look for ways to increase their efficiency. Again, this phenomenon has arguably been occurring in the once-protected markets of Eastern Europe, where many former state monopolies have had to increase the efficiency of their operations to survive in the competitive world market.

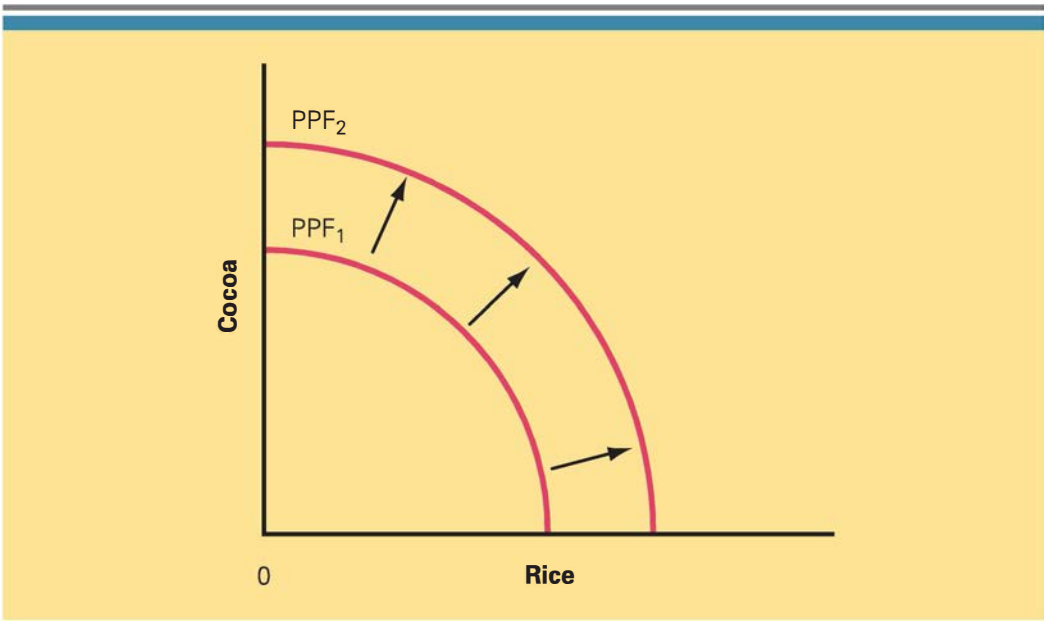
Dynamic gains in both the stock of a country's resources and the efficiency with which resources are utilized will cause a country's PPF to shift outward. This is illustrated in Figure 6.4, where the shift from PPF_1 to PPF_2 results from the dynamic gains that arise from free trade. As a consequence of this outward shift, the country in Figure 6.4 can produce more of both goods than it did before introduction of free trade. The theory suggests that opening an economy to free trade not only results in static gains of the type discussed earlier, but also results in dynamic gains that stimulate economic growth. If this is so, then one might think that the case for free trade becomes stronger still, and in general it does. However, as noted above, in a recent article one of the leading economic theorists of the twentieth century, Paul Samuelson, argued that in some circumstances, dynamic gains can lead to an outcome that is not so beneficial.

The Samuelson Critique

Paul Samuelson's critique looks at what happens when a rich country—the United States—enters into a free trade agreement with a poor country—China—that rapidly improves its productivity after the introduction of a free trade regime (i.e., there is a dynamic gain in the efficiency with which resources are used in the poor country). Samuelson's model suggests that in such cases, the lower prices that U.S. consumers

FIGURE 6.4

The Influence of Free Trade on the PPF



pay for goods imported from China following the introduction of a free trade regime *may* not be enough to produce a net gain for the U.S. economy if the dynamic effect of free trade is to lower real wage rates in the United States. As he stated in a *New York Times* interview, "Being able to purchase groceries 20 percent cheaper at Wal-Mart (due to international trade) does not necessarily make up for the wage losses (in America)."[12]

Samuelson goes on to note that he is particularly concerned about the ability to offshore service jobs that traditionally were not internationally mobile, such as software debugging, call center jobs, accounting jobs, and even medical diagnosis of MRI scans (see the accompanying Country Focus for details). Recent advances in communications technology have made this possible, effectively expanding the labor market for these jobs to include educated people in places such as India, the Philippines, and China. When coupled with rapid advances in the productivity of foreign labor due to better education, the effect on middle-class wages in the United States, according to Samuelson, may be similar to mass inward migration into the country: It will lower the market clearing wage rate, *perhaps* by enough to outweigh the positive benefits of international trade.

Having said this, it should be noted that Samuelson concedes that free trade has historically benefited rich counties (as data discussed below seems to confirm). Moreover, he notes that introducing protectionist measures (e.g., trade barriers) to guard against the theoretical possibility that free trade may harm the United States in the future may produce a situation that is worse than the disease they are trying to prevent. To quote Samuelson: "Free trade may turn out pragmatically to be still best for each region in comparison to lobbyist-induced tariffs and quotas which involve both a perversion of democracy and non-subtle deadweight distortion losses."[13]

Some economists have been quick to dismiss Samuelson's fears.[14] While not questioning his analysis, they note that as a practical matter developing nations are unlikely to be able to upgrade the skill level of their workforce rapidly enough to give rise to the situation in Samuelson's model. In other words, they will quickly run into diminishing returns. To quote one such rebuttal: "The notion that India and China will quickly educate 300 million of their citizens to acquire sophisticated and complex skills at stake borders on the ludicrous. The educational sectors in these countries face enormous difficulties."[15] Notwithstanding such rebuttals, however, Samuelson's stature is such that his work will undoubtedly be debated for some time to come.



COUNTRY FOCUS

Moving U.S. White-Collar Jobs Offshore

Economists have long argued that free trade produces gains for all countries that participate in a free trading system, but as the next wave of globalization sweeps through the U.S. economy, many people are wondering if this is true, particularly those who stand to lose their jobs because of this wave of globalization. In the popular imagination for much of the past quarter century, free trade was associated with the movement of low-skill, blue-collar manufacturing jobs out of rich countries such as the United States and toward low-wage countries—textiles to Costa Rica, athletic shoes to the Philippines, steel to Brazil, electronic products to Malaysia, and so on. While many observers bemoaned the "hollowing out" of U.S. manufacturing, economists stated that high-skilled and high-wage white-collar jobs associated with the knowledge-based economy would stay in the United States. Computers might be assembled in Malaysia, so the argument went, but they would continue to be designed in Silicon Valley by high-skilled U.S. engineers.

Recent developments have some people questioning this assumption. Over the past decade many American companies have been moving white-collar, knowledge-based jobs to developing nations where they could be performed for a fraction of the cost. During the long economic boom of the 1990s, Bank of America had to compete with other organizations for the scarce talents of information technology specialists, driving annual salaries to more than $100,000. However, with business under pressure, the bank cut nearly 5,000 jobs from its 25,000-strong, U.S.-based information technology workforce. Some of these jobs were transferred to India, where work that costs $100 an hour in the United States can be done for $20 an hour.

One beneficiary of Bank of America's downsizing is Infosys Technologies Ltd., a Bangalore, India, information technology firm where 250 engineers now develop information technology applications for the bank. Other Infosys employees are busy processing home loan applications for U.S. mortgage companies. Nearby in the offices of another Indian firm, Wipro Ltd., five radiologists interpret 30 CT scans a day for Massachusetts General Hospital that are sent over the Internet. At yet another Bangalore business, engineers earn $10,000 a year designing leading-edge semiconductor chips for Texas Instruments. Nor is India the only beneficiary of these changes. Accenture, a large U.S. management consulting and information technology firm, moved 5,000 jobs in software development and accounting to the Philippines. Also in the Philippines, Procter & Gamble employs 650 professionals who prepare the company's global tax returns. The work used to be done in the United States, but now it is done in Manila, with just final submission to local tax authorities in the United States and other countries handled locally.

Some architectural work also is being outsourced to lower-cost locations. Fluor Corp., a California-based construction company, employs some 1,200 engineers and draftsmen in the Philippines, Poland, and India to turn layouts of industrial facilities into detailed specifications. For a Saudi Arabian chemical plant Fluor is designing, 200 young engineers based in the Philippines earning less than $3,000 a year collaborate in real time over the Internet with elite U.S. and British engineers who make up to $90,000 a year. Why does Fluor do this? According to the company, the answer is simple. Doing so reduces the prices of a project by 15 percent, giving the company a cost-based competitive advantage in the global market for construction design.[16]

Evidence for the Link between Trade and Growth

LO3

Many economic studies have looked at the relationship between trade and economic growth.[17] In general, these studies suggest that, as predicted by the standard theory of comparative advantage, countries that adopt a more open stance toward international trade enjoy higher growth rates than those that close their economies to trade. Jeffrey Sachs and Andrew Warner created a measure of how "open" to international trade an economy was and then looked at the relationship between "openness" and economic

growth for a sample of more than 100 countries from 1970 to 1990.[18] Among other findings, they reported:

> We find a strong association between openness and growth, both within the group of developing and the group of developed countries. Within the group of developing countries, the open economies grew at 4.49 percent per year, and the closed economies grew at 0.69 percent per year. Within the group of developed economies, the open economies grew at 2.29 percent per year, and the closed economies grew at 0.74 percent per year.[19]

A study by Wacziarg and Welch updated the Sachs and Warner data through the late 1990s. They found that over the period 1950–1998, countries that liberalized their trade regimes experienced, on average, increases in their annual growth rates of 1.5 percent compared to pre-liberalization times.[20]

The message of these studies seems clear: Adopt an open economy and embrace free trade, and your nation will be rewarded with higher economic growth rates. Higher growth will raise income levels and living standards. This last point has been confirmed by a study that looked at the relationship between trade and growth in incomes. The study, undertaken by Jeffrey Frankel and David Romer, found that on average, a one percentage point increase in the ratio of a country's trade to its gross domestic product increases income per person by at least one-half percent.[21] For every 10 percent increase in the importance of international trade in an economy, average income levels will rise by at least 5 percent. Despite the short-term adjustment costs associated with adopting a free trade regime, trade would seem to produce greater economic growth and higher living standards in the long run, just as the theory of Ricardo would lead us to expect.[22]

LO2 Heckscher-Ohlin Theory

Ricardo's theory stresses that comparative advantage arises from differences in productivity. Thus, whether Ghana is more efficient than South Korea in the production of cocoa depends on how productively it uses its resources. Ricardo stressed labor productivity and argued that differences in labor productivity between nations underlie the notion of comparative advantage. Swedish economists Eli Heckscher (in 1919) and Bertil Ohlin (in 1933) put forward a different explanation of comparative advantage. They argued that comparative advantage arises from differences in national factor endowments.[23] By **factor endowments** they meant the extent to which a country is endowed with such resources as land, labor, and capital. Nations have varying factor endowments, and different factor endowments explain differences in factor costs; specifically, the more abundant a factor, the lower its cost. The Heckscher-Ohlin theory predicts that countries will export those goods that make intensive use of factors that are locally abundant, while importing goods that make intensive use of factors that are locally scarce. Thus, the Heckscher-Ohlin theory attempts to explain the pattern of international trade that we observe in the world economy. Like Ricardo's theory, the Heckscher-Ohlin theory argues that free trade is beneficial. Unlike Ricardo's theory, however, the Heckscher-Ohlin theory argues that the pattern of international trade is determined by differences in factor endowments, rather than differences in productivity.

The Heckscher-Ohlin theory has commonsense appeal. For example, the United States has long been a substantial exporter of agricultural goods, reflecting in part its unusual abundance of arable land. In contrast, China excels in the export of goods produced in labor-intensive manufacturing industries, such as textiles and footwear. This reflects China's relative abundance of low-cost labor. The United States, which lacks abundant low-cost labor, has been a primary importer of these goods. Note that it is relative, not absolute, endowments that are important; a country may have larger absolute amounts of land and labor than another country, but be relatively abundant in one of them.

THE LEONTIEF PARADOX

The Heckscher-Ohlin theory has been one of the most influential theoretical ideas in international economics. Most economists prefer the Heckscher-Ohlin theory to Ricardo's theory because it makes fewer simplifying assumptions. Because of its influence, the theory has been subjected to many empirical tests. Beginning with a famous study published in 1953 by Wassily Leontief (winner of the Nobel Prize in economics in 1973), many of these tests have raised questions about the validity of the Heckscher-Ohlin theory.[24] Using the Heckscher-Ohlin theory, Leontief postulated that since the United States was relatively abundant in capital compared to other nations, the United States would be an exporter of capital-intensive goods and an importer of labor-intensive goods. To his surprise, however, he found that U.S. exports were less capital intensive than U.S. imports. Since this result was at variance with the predictions of the theory, it has become known as the Leontief paradox.

No one is quite sure why we observe the Leontief paradox. One possible explanation is that the United States has a special advantage in producing new products or goods made with innovative technologies. Such products may be less capital intensive than products whose technology has had time to mature and become suitable for mass production. Thus, the United States may be exporting goods that heavily use skilled labor and innovative entrepreneurship, such as computer software, while importing heavy manufacturing products that use large amounts of capital. Some empirical studies tend to confirm this.[25] Still, tests of the Heckscher-Ohlin theory using data for a large number of countries tend to confirm the existence of the Leontief paradox.[26]

This leaves economists with a difficult dilemma. They prefer the Heckscher-Ohlin theory on theoretical grounds, but it is a relatively poor predictor of real-world international trade patterns. On the other hand, the theory they regard as being too limited, Ricardo's theory of comparative advantage, actually predicts trade patterns with greater accuracy. The best solution to this dilemma may be to return to the Ricardian idea that trade patterns are largely driven by international differences in productivity. Thus, one might argue that the United States exports commercial aircraft and imports textiles not because its factor endowments are especially suited to aircraft manufacture and not suited to textile manufacture, but because the United States is relatively more efficient at producing aircraft than textiles. A key assumption in the Heckscher-Ohlin theory is that technologies are the same across countries. This may not be the case. Differences in technology may lead to differences in productivity, which in turn, drives international trade patterns.[27] Thus, Japan's success in exporting automobiles from the 1970s onwards has been based not just on the relative abundance of capital, but also on its development of innovative manufacturing technology that enabled it to achieve higher productivity levels in automobile production than other countries that also had abundant capital. More recent empirical work suggests that this theoretical explanation may be correct.[28] The new research shows that once differences in technology across countries are controlled for, countries do indeed export those goods that make intensive use of factors that are locally abundant, while importing goods that make intensive use of factors that are locally scarce. In other words, once the impact of differences of technology on productivity is controlled for, the Heckscher-Ohlin theory seems to gain predictive power.

The Product Life-Cycle Theory LO2

Raymond Vernon initially proposed the product life-cycle theory in the mid-1960s.[29] Vernon's theory was based on the observation that for most of the twentieth century a very large proportion of the world's new products had been developed by U.S. firms and sold first in the U.S. market (e.g., mass-produced automobiles, televisions, instant cameras, photocopiers, personal computers, and semiconductor chips). To explain this, Vernon argued that the wealth and size of the U.S. market gave U.S. firms a strong

incentive to develop new consumer products. In addition, the high cost of U.S. labor gave U.S. firms an incentive to develop cost-saving process innovations.

Just because a new product is developed by a U.S. firm and first sold in the U.S. market, it does not follow that the product must be produced in the United States. It could be produced abroad at some low-cost location and then exported back into the United States. However, Vernon argued that most new products were initially produced in America. Apparently, the pioneering firms believed it was better to keep production facilities close to the market and to the firm's center of decision making, given the uncertainty and risks inherent in introducing new products. Also, the demand for most new products tends to be based on nonprice factors. Consequently, firms can charge relatively high prices for new products, which obviates the need to look for low-cost production sites in other countries.

Vernon went on to argue that early in the life cycle of a typical new product, while demand is starting to grow rapidly in the United States, demand in other advanced countries is limited to high-income groups. The limited initial demand in other advanced countries does not make it worthwhile for firms in those countries to start producing the new product, but it does necessitate some exports from the United States to those countries.

Over time, demand for the new product starts to grow in other advanced countries (e.g., Great Britain, France, Germany, and Japan). As it does, it becomes worthwhile for foreign producers to begin producing for their home markets. In addition, U.S. firms might set up production facilities in those advanced countries where demand is growing. Consequently, production within other advanced countries begins to limit the potential for exports from the United States.

As the market in the United States and other advanced nations matures, the product becomes more standardized, and price becomes the main competitive weapon. As this occurs, cost considerations start to play a greater role in the competitive process. Producers based in advanced countries where labor costs are lower than in the United States (e.g., Italy, Spain) might now be able to export to the United States. If cost pressures become intense, the process might not stop there. The cycle by which the United States lost its advantage to other advanced countries might be repeated once more, as developing countries (e.g., Thailand) begin to acquire a production advantage over advanced countries. Thus, the locus of global production initially switches from the United States to other advanced nations and then from those nations to developing countries.

The consequence of these trends for the pattern of world trade is that over time the United States switches from being an exporter of the product to an importer of the product as production becomes concentrated in lower-cost foreign locations. Figure 6.5 shows the growth of production and consumption over time in the United States, other advanced countries, and developing countries.

EVALUATING THE PRODUCT LIFE-CYCLE THEORY

Historically, the product life-cycle theory seems to be an accurate explanation of international trade patterns. Consider photocopiers; the product was first developed in the early 1960s by Xerox in the United States and sold initially to U.S. users. Originally Xerox exported photocopiers from the United States, primarily to Japan and the advanced countries of Western Europe. As demand began to grow in those countries, Xerox entered into joint ventures to set up production in Japan (Fuji-Xerox) and Great Britain (Rank-Xerox). In addition, once Xerox's patents on the photocopier process expired, other foreign competitors began to enter the market (e.g., Canon in Japan, Olivetti in Italy). As a consequence, exports from the United States declined, and U.S. users began to buy some of their photocopiers from lower-cost foreign sources, particularly Japan. More recently, Japanese companies have found that manufacturing costs are too high in their own country, so they have begun to switch production to developing countries such as Singapore and Thailand. Thus, initially the United States and now other advanced countries (e.g., Japan and Great Britain) have switched from being

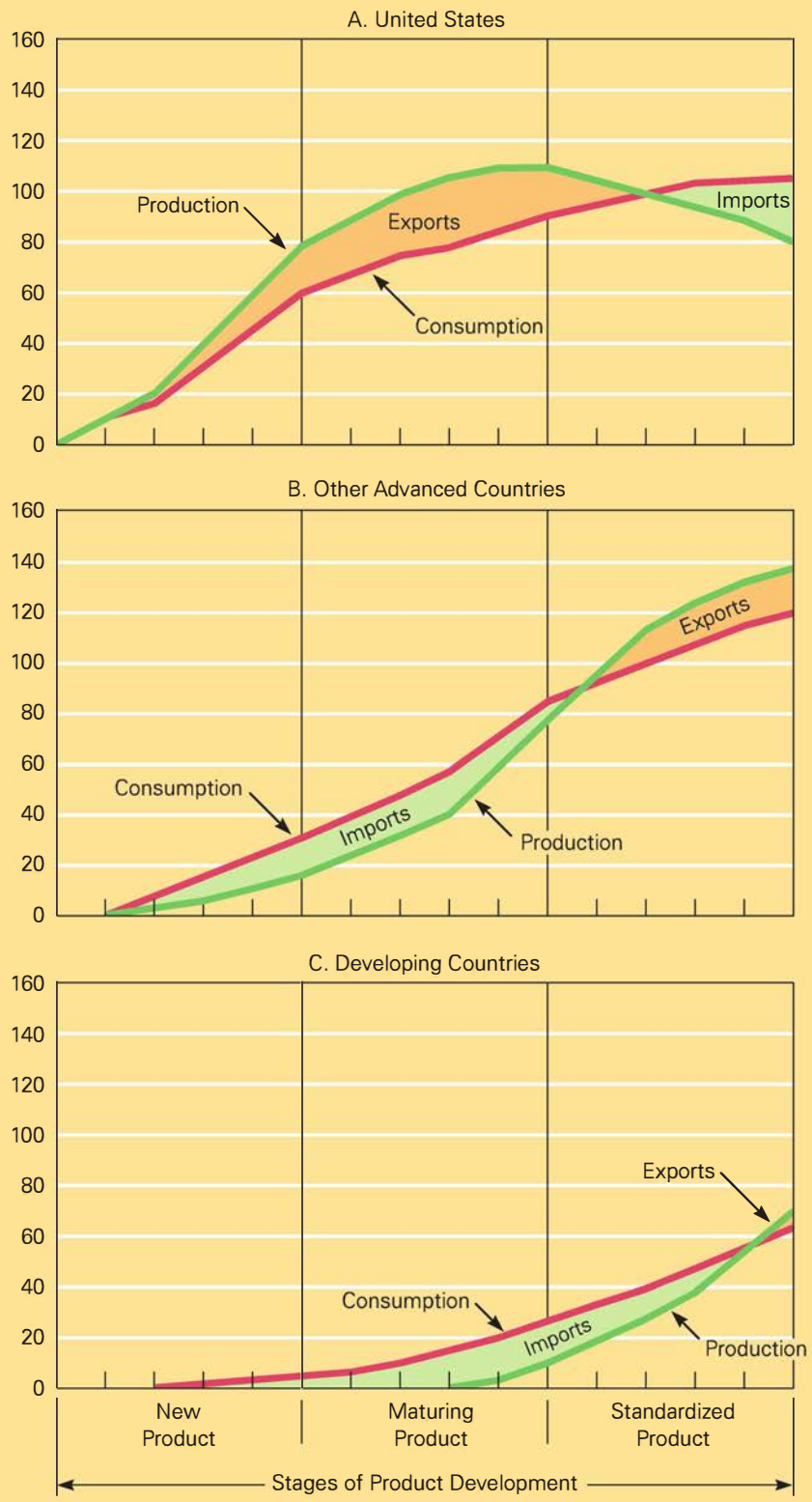


FIGURE 6.5

The Product Life-Cycle Theory

Source: Adapted from Raymond Vernon and Louis T. Wells, *The Economic Environment of International Business*, 5th edition © 1991. Reproduced by permission of Pearson Education, Inc., Upper Saddle River, New Jersey.

exporters of photocopiers to importers. This evolution in the pattern of international trade in photocopiers is consistent with the predictions of the product life-cycle theory that mature industries tend to go out of the United States and into low-cost assembly locations.

However, the product life-cycle theory is not without weaknesses. Viewed from an Asian or European perspective, Vernon's argument that most new products are developed and introduced in the United States seems ethnocentric and increasingly dated. Although it may be true that during U.S. dominance of the global economy (from 1945 to 1975), most new products were introduced in the United States, there have always been important exceptions. These exceptions appear to have become more common in recent years. Many new products are now first introduced in Japan (e.g., videogame consoles) or Europe (new wireless phones). Moreover, with the increased globalization and integration of the world economy discussed in Chapter 1, a growing number of new products (e.g., laptop computers, compact disks, and digital cameras) are now introduced simultaneously in the United States, Japan, and the advanced European nations. This may be accompanied by globally dispersed production, with particular components of a new product being produced in those locations around the globe where the mix of factor costs and skills is most favorable (as predicted by the theory of comparative advantage). In sum, although Vernon's theory may be useful for explaining the pattern of international trade during the period of American global dominance, its relevance in the modern world seems more limited.

LO2 New Trade Theory

The new trade theory began to emerge in the 1970s when a number of economists pointed out that the ability of firms to attain economies of scale might have important implications for international trade.[30] **Economies of scale** are unit cost reductions associated with a large scale of output. Economies of scale have a number of sources, including the ability to spread fixed costs over a large volume, and the ability of large-volume producers to utilize specialized employees and equipment that are more productive than less specialized employees and equipment. Economies of scale are a major source of cost reductions in many industries, from computer software to automobiles, and from pharmaceuticals to aerospace. For example, Microsoft realizes economies of scale by spreading the fixed costs of developing new versions of its Windows operating system, which runs to about $5 billion, over the 250 million or so personal computers upon which each new system is ultimately installed. Similarly, automobile companies realize economies of scale by producing a high volume of automobiles from an assembly line where each employee has a specialized task.

New trade theory makes two important points: First, through its impact on economies of scale, trade can increase the variety of goods available to consumers and decrease the average cost of those goods. Second, in those industries when the output required to attain economies of scale represents a significant proportion of total world demand, the global market may be able to support only a small number of enterprises. Thus, world trade in certain products may be dominated by countries whose firms were first movers in their production.

LO3 INCREASING PRODUCT VARIETY AND REDUCING COSTS

Imagine first a world without trade. In industries where economies of scale are important, both the variety of goods that a country can produce and the scale of production are limited by the size of the market. If a national market is small, there may not be enough demand to enable producers to realize economies of scale for certain products. Accordingly, those products may not be produced, thereby limiting the variety of products available to consumers. Alternatively, they may be produced, but at such low volumes that unit costs and prices are considerably higher than they might be if economies of scale could be realized.

Now consider what happens when nations trade with each other. Individual national markets are combined into a larger world market. As the size of the market expands due

to trade, individual firms may be able to better attain economies of scale. The implication, according to new trade theory, is that each nation may be able to specialize in producing a narrower range of products than it would in the absence of trade, yet by buying goods that it does not make from other countries, each nation can simultaneously increase the *variety* of goods available to its consumers and *lower the costs* of those goods—thus trade offers an opportunity for mutual gain even when countries do not differ in their resource endowments or technology.

Suppose there are two countries, each with an annual market for 1 million automobiles. By trading with each other, these countries can create a combined market for 2 million cars. In this combined market, due to the ability to better realize economies of scale, more varieties (models) of cars can be produced, and cars can be produced at a lower average cost, than in either market alone. For example, demand for a sports car may be limited to 55,000 units in each national market, while a total output of at least 100,000 per year may be required to realize significant scale economies. Similarly, demand for a minivan may be 80,000 units in each national market, and again a total output of at least 100,000 per year may be required to realize significant scale economies. Faced with limited domestic market demand, firms in each nation may decide not to produce a sports car, since the costs of doing so at such low volume are too great. Although they may produce minivans, the cost of doing so will be higher, as will prices, than if significant economies of scale had been attained. Once the two countries decide to trade, however, a firm in one nation may specialize in producing sports cars, while a firm in the other nation may produce minivans. The combined demand for 110,000 sports cars and 160,000 minivans allows each firm to realize scale economies. Consumers in this case benefit from having access to a product (sports cars) that was not available before international trade and from the lower price for a product (minivans) that could not be produced at the most efficient scale before international trade. Trade is thus mutually beneficial because it allows for the specialization of production, the realization of scale economies, the production of a greater variety of products, and lower prices.

ECONOMIES OF SCALE, FIRST-MOVER ADVANTAGES, AND THE PATTERN OF TRADE

A second theme in new trade theory is that the pattern of trade we observe in the world economy may be the result of economies of scale and first-mover advantages. **First-mover advantages** are the economic and strategic advantages that accrue to early entrants into an industry.[31] The ability to capture scale economies ahead of later entrants, and thus benefit from a lower cost structure, is an important first-mover advantage. New trade theory argues that for those products where economies of scale are significant and represent a substantial proportion of world demand, the first movers in an industry can gain a scale-based cost advantage that later entrants find almost impossible to match. Thus, the pattern of trade that we observe for such products may reflect first-mover advantages. Countries may dominate in the export of certain goods because economies of scale are important in their production, and because firms located in those countries were the first to capture scale economies, giving them a first-mover advantage.

For example, consider the commercial aerospace industry. In aerospace there are substantial scale economies that come from the ability to spread the fixed costs of developing a new jet aircraft over a large number of sales. It has cost Airbus Industrie some $15 billion to develop its new super-jumbo jet, the 550-seat A380. To recoup those costs and break even, Airbus will have to sell at least 250 A380 planes. If Airbus can sell more than 350 A380 planes, it will apparently be a profitable venture. Total demand over the next 20 years for this class of aircraft is estimated to be between 400 and 600 units. Thus, the global market can probably profitably support only one producer of jet aircraft in the super-jumbo category. It follows that the European Union might come to dominate in the export of very large jet aircraft, primarily because a European-based firm, Airbus, was the first to produce a super-jumbo jet aircraft and realize scale economies. Other potential

producers, such as Boeing, might be shut out of the market because they will lack the scale economies that Airbus will enjoy. By pioneering this market category, Airbus may have captured a *first-mover advantage* based on *scale economies* that will be difficult for rivals to match, and that will result in the European Union becoming the *leading exporter* of very large jet aircraft. (Boeing does not believe the market to be large enough to even profitably support one producer, hence its decision not to build a similar aircraft, and instead focus on its super efficient 787.)

LO3 IMPLICATIONS OF NEW TRADE THEORY

New trade theory has important implications. The theory suggests that nations may benefit from trade even when they do not differ in resource endowments or technology. Trade allows a nation to specialize in the production of certain products, attaining scale economies and lowering the costs of producing those products, while buying products that it does not produce from other nations that specialize in the production of other products. By this mechanism, the variety of products available to consumers in each nation is increased, while the average costs of those products should fall, as should their price, freeing resources to produce other goods and services.

The theory also suggests that a country may predominate in the export of a good simply because it was lucky enough to have one or more firms among the first to produce that good. Because they are able to gain economies of scale, the first movers in an industry may get a lock on the world market that discourages subsequent entry. First movers' ability to benefit from increasing returns creates a barrier to entry. In the commercial aircraft industry, the fact that Boeing and Airbus are already in the industry and have the benefits of economies of scale discourages new entry and reinforces the dominance of America and Europe in the trade of midsize and large jet aircraft. This dominance is further reinforced because global demand may not be sufficient to profitably support another producer of midsize and large jet aircraft in the industry. So although Japanese firms might be able to compete in the market, they have decided not to enter the industry but to ally themselves as major subcontractors with primary producers (e.g., Mitsubishi Heavy Industries is a major subcontractor for Boeing on the 777 and 787 programs).

New trade theory is at variance with the Heckscher-Ohlin theory, which suggests a country will predominate in the export of a product when it is particularly well endowed with those factors used intensively in its manufacture. New trade theorists argue that the United States is a major exporter of commercial jet aircraft not because it is better endowed with the factors of production required to manufacture aircraft, but because one of the first movers in the industry, Boeing, was a U.S. firm. The new trade theory is not at variance with the theory of comparative advantage. Economies of scale increase productivity. Thus, the new trade theory identifies an important source of comparative advantage.

This theory is quite useful in explaining trade patterns. Empirical studies seem to support the predictions of the theory that trade increases the specialization of production within an industry, increases the variety of products available to consumers, and results in lower average prices.[32] With regard to first-mover advantages and international trade, a study by Harvard business historian Alfred Chandler suggests the existence of first-mover advantages is an important factor in explaining the dominance of firms from certain nations in specific industries.[33] The number of firms is very limited in many global industries, including the chemical industry, the heavy construction-equipment industry, the heavy truck industry, the tire industry, the consumer electronics industry, the jet engine industry, and the computer software industry.

LO4 Perhaps the most contentious implication of the new trade theory is the argument that it generates for government intervention and strategic trade policy.[34] New trade theorists stress the role of luck, entrepreneurship, and innovation in giving a firm first-mover advantages. According to this argument, the reason Boeing was the first mover in commercial jet aircraft manufacture—rather than firms such as Great Britain's DeHavilland and Hawker Siddley, or Holland's Fokker, all of which could have been—

was that Boeing was both lucky and innovative. One way Boeing was lucky is that DeHavilland shot itself in the foot when its Comet jet airliner, introduced two years earlier than Boeing's first jet airliner, the 707, was found to be full of serious technological flaws. Had DeHavilland not made some serious technological mistakes, Great Britain might have become the world's leading exporter of commercial jet aircraft. Boeing's innovativeness was demonstrated by its independent development of the technological know-how required to build a commercial jet airliner. Several new trade theorists have pointed out, however, that Boeing's R&D was largely paid for by the U.S. government; the 707 was a spin-off from a government-funded military program (the entry of Airbus into the industry was also supported by significant government subsidies). Herein is a rationale for government intervention; by the sophisticated and judicious use of subsidies, could a government increase the chances of its domestic firms becoming first movers in newly emerging industries, as the U.S. government apparently did with Boeing (and the European Union did with Airbus)? If this is possible, and the new trade theory suggests it might be, we have an economic rationale for a proactive trade policy that is at variance with the free trade prescriptions of the trade theories we have reviewed so far. We will consider the policy implications of this issue in Chapter 7.

National Competitive Advantage: Porter's Diamond

LO2

In 1990 Michael Porter of the Harvard Business School published the results of an intensive research effort that attempted to determine why some nations succeed and others fail in international competition.[35] Porter and his team looked at 100 industries in 10 nations. Like the work of the new trade theorists, Porter's work was driven by a belief that existing theories of international trade told only part of the story. For Porter, the essential task was to explain why a nation achieves international success in a particular industry. Why does Japan do so well in the automobile industry? Why does Switzerland excel in the production and export of precision instruments and pharmaceuticals? Why do Germany and the United States do so well in the chemical industry? These questions cannot be answered easily by the Heckscher-Ohlin theory, and the theory of comparative advantage offers only a partial explanation. The theory of comparative advantage would say that Switzerland excels in the production and export of precision instruments because it uses its resources very productively in these industries. Although this may be correct, this does not explain why Switzerland is more productive in this industry than Great Britain, Germany, or Spain. Porter tries to solve this puzzle.

Porter theorizes that four broad attributes of a nation shape the environment in which local firms compete, and these attributes promote or impede the creation of competitive advantage (see Figure 6.6). These attributes are

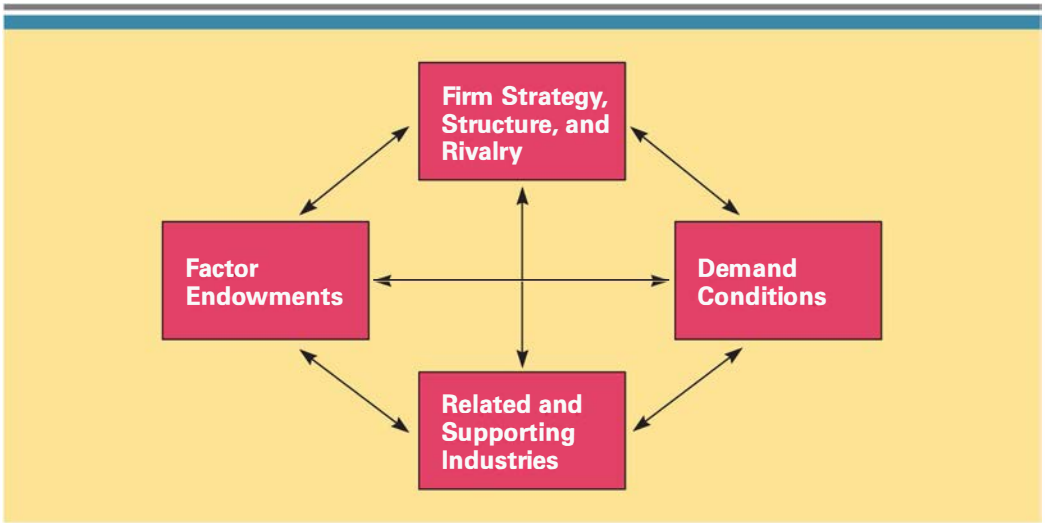
- *Factor endowments*—a nation's position in factors of production such as skilled labor or the infrastructure necessary to compete in a given industry.
- *Demand conditions*—the nature of home demand for the industry's product or service.
- *Relating and supporting industries*—the presence or absence of supplier industries and related industries that are internationally competitive.
- *Firm strategy, structure, and rivalry*—the conditions governing how companies are created, organized, and managed and the nature of domestic rivalry.

Porter speaks of these four attributes as constituting the *diamond*. He argues that firms are most likely to succeed in industries or industry segments where the diamond is most favorable. He also argues that the diamond is a mutually reinforcing system. The effect of one attribute is contingent on the state of others. For example, Porter argues favorable

FIGURE 6.6

Determinants of National Competitive Advantage: Porter's Diamond

Source: Reprinted by permission of *Harvard Business Review*. Exhibit from "The Competitive Advantage of Nations," by Michael E. Porter, March–April 1990, p. 77. Copyright 1990 by the Harvard Business School Publishing Corporation; all rights reserved.



demand conditions will not result in competitive advantage unless the state of rivalry is sufficient to cause firms to respond to them.

Porter maintains that two additional variables can influence the national diamond in important ways: chance and government. Chance events, such as major innovations, can reshape industry structure and provide the opportunity for one nation's firms to supplant another's. Government, by its choice of policies, can detract from or improve national advantage. For example, regulation can alter home demand conditions, antitrust policies can influence the intensity of rivalry within an industry, and government investments in education can change factor endowments.

FACTOR ENDOWMENTS

Factor endowments lie at the center of the Heckscher-Ohlin theory. While Porter does not propose anything radically new, he does analyze the characteristics of factors of production. He recognizes hierarchies among factors, distinguishing between *basic factors* (e.g., natural resources, climate, location, and demographics) and *advanced factors* (e.g., communication infrastructure, sophisticated and skilled labor, research facilities, and technological know-how). He argues that advanced factors are the most significant for competitive advantage. Unlike the naturally endowed basic factors, advanced factors are a product of investment by individuals, companies, and governments. Thus, government investments in basic and higher education, by improving the general skill and knowledge level of the population and by stimulating advanced research at higher education institutions, can upgrade a nation's advanced factors.

The relationship between advanced and basic factors is complex. Basic factors can provide an initial advantage that is subsequently reinforced and extended by investment in advanced factors. Conversely, disadvantages in basic factors can create pressures to invest in advanced factors. An obvious example of this phenomenon is Japan, a country that lacks arable land and mineral deposits and yet through investment has built a substantial endowment of advanced factors. Porter notes that Japan's large pool of engineers (reflecting a much higher number of engineering graduates per capita than almost any other nation) has been vital to Japan's success in many manufacturing industries.

DEMAND CONDITIONS

Porter emphasizes the role home demand plays in upgrading competitive advantage. Firms are typically most sensitive to the needs of their closest customers. Thus, the characteristics of home demand are particularly important in shaping the attributes of domestically made products and in creating pressures for innovation and quality. Porter argues that a nation's firms gain competitive advantage if their domestic consumers are

sophisticated and demanding. Such consumers pressure local firms to meet high standards of product quality and to produce innovative products. Porter notes that Japan's sophisticated and knowledgeable buyers of cameras helped stimulate the Japanese camera industry to improve product quality and to introduce innovative models. A similar example can be found in the wireless telephone equipment industry, where sophisticated and demanding local customers in Scandinavia helped push Nokia of Finland and Ericsson of Sweden to invest in cellular phone technology long before demand for cellular phones took off in other developed nations. The case of Nokia is reviewed in more depth in the accompanying Management Focus.

RELATED AND SUPPORTING INDUSTRIES

The third broad attribute of national advantage in an industry is the presence of suppliers or related industries that are internationally competitive. The benefits of investments in advanced factors of production by related and supporting industries can spill over into an industry, thereby helping it achieve a strong competitive position internationally. Swedish strength in fabricated steel products (e.g., ball bearings and cutting tools) has drawn on strengths in Sweden's specialty steel industry. Technological leadership in the U.S. semiconductor industry provided the basis for U.S. success in personal computers and several other technically advanced electronic products. Similarly, Switzerland's success in pharmaceuticals is closely related to its previous international success in the technologically related dye industry.

One consequence of this process is that successful industries within a country tend to be grouped into clusters of related industries. This was one of the most pervasive findings of Porter's study. One such cluster Porter identified was in the German textile and apparel sector, which included high-quality cotton, wool, synthetic fibers, sewing machine needles, and a wide range of textile machinery. Such clusters are important, because valuable knowledge can flow between the firms within a geographic cluster, benefiting all within that cluster. Knowledge flows occur when employees move between firms within a region and when national industry associations bring employees from different companies together for regular conferences or workshops.[36]

FIRM STRATEGY, STRUCTURE, AND RIVALRY

The fourth broad attribute of national competitive advantage in Porter's model is the strategy, structure, and rivalry of firms within a nation. Porter makes two important points here. First, different nations are characterized by different management ideologies, which either help them or do not help them to build national competitive advantage. For example, Porter noted the predominance of engineers in top management at German and Japanese firms. He attributed this to these firms' emphasis on improving manufacturing processes and product design. In contrast, Porter noted a predominance of people with finance backgrounds leading many U.S. firms. He linked this to U.S. firms' lack of attention to improving manufacturing processes and product design. He argued that the dominance of finance led to an overemphasis on maximizing short-term financial returns. According to Porter, one consequence of these different management ideologies was a relative loss of U.S. competitiveness in those engineering-based industries where manufacturing processes and product design issues are all-important (e.g., the automobile industry).

Porter's second point is that there is a strong association between vigorous domestic rivalry and the creation and persistence of competitive advantage in an industry. Vigorous domestic rivalry induces firms to look for ways to improve efficiency, which makes them better international competitors. Domestic rivalry creates pressures to innovate, to improve quality, to reduce costs, and to invest in upgrading advanced factors. All this helps to create world-class competitors. Porter cites the case of Japan:

> Nowhere is the role of domestic rivalry more evident than in Japan, where it is all-out warfare in which many companies fail to achieve profitability. With goals that stress



MANAGEMENT FOCUS

The Rise (and Fall) of Finland's Nokia

The wireless phone market is one of the great growth stories of the past 20 years. Starting from a low base in 1990, annual global sales of wireless phones surged to reach about 1.3 billion units in 2010. By the end of 2010, the number of wireless subscriber accounts worldwide was some 4.5 billion, up from less than 10 million in 1990. Nokia is one of the dominant players in the world market for mobile phones with around a 37 percent share of the market in 2010. Nokia's roots are in Finland, not normally a country that comes to mind when one talks about leading-edge technology companies. In the 1980s, Nokia was a rambling Finnish conglomerate with activities that embraced tire manufacturing, paper production, consumer electronics, and telecommunications equipment. By the early 2000s it had transformed itself into a focused telecommunications equipment manufacturer with a global reach. How did this former conglomerate emerge to take a global leadership position in wireless telecommunications equipment? Much of the answer lies in the history, geography, and political economy of Finland and its Nordic neighbors.

In 1981 the Nordic nations cooperated to create the world's first international wireless telephone network. They had good reason to become pioneers: It cost far too much to lay a traditional wire line telephone service in those sparsely populated and inhospitably cold countries. The same features made telecommunications all the more valuable: People driving through the Arctic winter and owners of remote northern houses needed a telephone to summon help if things went wrong. As a result, Sweden, Norway, and Finland became the first nations in the world to take wireless telecommunications seriously. They found, for example, that although it cost up to $800 per subscriber to bring a traditional wire line service to remote locations, the same locations could be linked by wireless cellular for only $500 per person. As a consequence, 12 percent of people in Scandinavia owned cellular phones by 1994, compared with less than 6 percent in the United States, the world's second most developed market. This lead continued over the next decade. By 2008, 90 percent of the population in Finland owned a wireless phone, compared with 70 percent in the United States.

Nokia, a long-time telecommunications equipment supplier, was well positioned to take advantage of this development from the start, but other forces were also at work to help Nokia develop its competitive edge. Unlike virtually every other developed nation, Finland has never had a national telephone monopoly. Instead, the country's telephone services have long been provided by about 50 autonomous local telephone companies whose elected boards set prices by referendum (which naturally means low prices). This army of independent and cost-conscious telephone service providers prevented Nokia from taking anything for granted in its home country. With typical Finnish pragmatism, its customers were willing to buy from the lowest-cost supplier, whether that was Nokia, Ericsson, Motorola, or some other company. This situation contrasted sharply with that prevailing in most developed nations until the late 1980s and early 1990s, where domestic telephone monopolies typically purchased equipment from a dominant local supplier or made it themselves. Nokia responded to this competitive pressure by doing everything possible to drive down its manufacturing costs while staying at the leading edge of wireless technology. This all enabled Nokia to emerge as a leader in digital wireless technology.

However, there are now problems on the horizon for Nokia. In the past few years it has lost leadership in the lucrative market for smartphones to companies such as Apple and Blackberry. While Nokia's market share is still strong, its margins are being compressed. For too long the company clung to the idea that handsets were mainly about calling people and failed to notice that web-based applications were driving demand for products such as the iPhone. Why did the onetime technology leader make this mistake? According to some critics, Nokia was too isolated from web-based companies and other consumer electronics enterprises, whereas Apple, being based in California's Silicon Valley, was surrounded by them. This meant that unlike Apple (and Google, whose Android operating system powers many smartphones), Nokia wasn't exposed to the mix of innovative ideas swirling around Silicon Valley. Location, initially a Nokia advantage, had now become a disadvantage.[37]

market share, Japanese companies engage in a continuing struggle to outdo each other. Shares fluctuate markedly. The process is prominently covered in the business press. Elaborate rankings measure which companies are most popular with university graduates. The rate of new product and process development is breathtaking.[38]

A similar point about the stimulating effects of strong domestic competition can be made with regard to the rise of Nokia of Finland to global preeminence in the market for cellular telephone equipment. For details, see the accompanying Management Focus.

EVALUATING PORTER'S THEORY

LO4

Porter contends that the degree to which a nation is likely to achieve international success in a certain industry is a function of the combined impact of factor endowments, domestic demand conditions, related and supporting industries, and domestic rivalry. He argues that the presence of all four components is usually required for this diamond to boost competitive performance (although there are exceptions). Porter also contends that government can influence each of the four components of the diamond—either positively or negatively. Factor endowments can be affected by subsidies, policies toward capital markets, policies toward education, and so on. Government can shape domestic demand through local product standards or with regulations that mandate or influence buyer needs. Government policy can influence supporting and related industries through regulation and influence firm rivalry through such devices as capital market regulation, tax policy, and antitrust laws.

If Porter is correct, we would expect his model to predict the pattern of international trade that we observe in the real world. Countries should be exporting products from those industries where all four components of the diamond are favorable, while importing in those areas where the components are not favorable. Is he correct? We simply do not know. Porter's theory has not been subjected to detailed empirical testing. Much about the theory rings true, but the same can be said for the new trade theory, the theory of comparative advantage, and the Heckscher-Ohlin theory. It may be that each of these theories, which complement each other, explains something about the pattern of international trade.

IMPLICATIONS FOR MANAGERS



Why does all this matter for business? There are at least three main implications for international businesses of the material discussed in this chapter: location implications, first-mover implications, and policy implications.

LO5

LOCATION

Underlying most of the theories we have discussed is the notion that different countries have particular advantages in different productive activities. Thus, from a profit perspective, it makes sense for a firm to disperse its productive activities to those countries where, according to the theory of international trade, they can be performed most efficiently. If design can be performed most efficiently in France, that is where design facilities should be located; if the manufacture of basic components can be performed most efficiently in Singapore, that is where they should be manufactured; and if final assembly can be performed most efficiently in China, that is where final assembly should be performed. The result is a global web of productive activities, with

different activities being performed in different locations around the globe depending on considerations of comparative advantage, factor endowments, and the like. If the firm does not do this, it may find itself at a competitive disadvantage relative to firms that do.

Consider the production of a laptop computer, a process with four major stages: (1) basic research and development of the product design, (2) manufacture of standard electronic components (e.g., memory chips), (3) manufacture of advanced components (e.g., flat-top color display screens and microprocessors), and (4) final assembly. Basic R&D requires a pool of highly skilled and educated workers with good backgrounds in microelectronics. The two countries with a comparative advantage in basic microelectronics R&D and design are Japan and the United States, so most producers of laptop computers locate their R&D facilities in one, or both, of these countries. (Apple, IBM, Motorola, Texas Instruments, Toshiba, and Sony all have major R&D facilities in both Japan and the United States.)

The manufacture of standard electronic components is a capital-intensive process requiring semiskilled labor, and cost pressures are intense. The best locations for such activities today are places such as China, Taiwan, Malaysia, and South Korea. These countries have pools of relatively skilled, moderate-cost labor. Thus, many producers of laptop computers have standard components, such as memory chips, produced at these locations.

The manufacture of advanced components such as microprocessors is a capital-intensive process requiring skilled labor. Because cost pressures are not so intense at this stage, these components can be—and are—manufactured in countries with high labor costs that also have pools of highly skilled labor (e.g., Japan and the United States).

Finally, assembly is a relatively labor-intensive process requiring only low-skilled labor, and cost pressures are intense. As a result, final assembly may be carried out in a country such as Mexico, which has an abundance of low-cost, low-skilled labor. A laptop computer produced by a U.S. manufacturer may be designed in California, have its standard components produced in Taiwan and Singapore, its advanced components produced in Japan and the United States, its final assembly in Mexico, and be sold in the United States or elsewhere in the world. By dispersing production activities to different locations around the globe, the U.S. manufacturer is taking advantage of the differences between countries identified by the various theories of international trade.

FIRST-MOVER ADVANTAGES

According to the new trade theory, firms that establish a first-mover advantage with regard to the production of a particular new product may subsequently dominate global trade in that product. This is particularly true in industries where the global market can profitably support only a limited number of firms, such as the aerospace market, but early commitments also seem to be important in less concentrated industries such as the market for cellular telephone equipment (see the Management Focus on Nokia). For the individual firm, the clear message is that it pays to invest substantial financial resources in trying to build a first-mover, or early-mover, advantage, even if that means several years of losses before a new venture becomes profitable. The idea is to preempt the available demand, gain cost advantages related to volume, build an enduring brand ahead of later competitors, and, consequently, establish a long-term sustainable competitive advantage. Although the details of how to achieve this are beyond the scope of this book, many publications offer strategies for exploiting first-mover advantages, and for avoiding the traps associated with pioneering a market (first-mover disadvantages).[39]

GOVERNMENT POLICY

The theories of international trade also matter to international businesses because firms are major players on the international trade scene. Business firms produce exports, and business firms import the products of other countries. Because of their pivotal role in

international trade, businesses can exert a strong influence on government trade policy, lobbying to promote free trade or trade restrictions. The theories of international trade claim that promoting free trade is generally in the best interests of a country, although it may not always be in the best interest of an individual firm. Many firms recognize this and lobby for open markets.

For example, when the U.S. government announced its intention to place a tariff on Japanese imports of liquid crystal display (LCD) screens in the 1990s, IBM and Apple Computer protested strongly. Both IBM and Apple pointed out that (1) Japan was the lowest-cost source of LCD screens, (2) they used these screens in their own laptop computers, and (3) the proposed tariff, by increasing the cost of LCD screens, would increase the cost of laptop computers produced by IBM and Apple, thus making them less competitive in the world market. In other words, the tariff, designed to protect U.S. firms, would be self-defeating. In response to these pressures, the U.S. government reversed its posture.

Unlike IBM and Apple, however, businesses do not always lobby for free trade. In the United States, for example, restrictions on imports of steel are the result of direct pressure by U.S. firms on the government. In some cases, the government has responded to pressure by getting foreign companies to agree to "voluntary" restrictions on their imports, using the implicit threat of more comprehensive formal trade barriers to get them to adhere to these agreements (historically, this has occurred in the automobile industry). In other cases, the government used what are called "antidumping" actions to justify tariffs on imports from other nations (these mechanisms will be discussed in detail in the next chapter).

As predicted by international trade theory, many of these agreements have been self-defeating, such as the voluntary restriction on machine tool imports agreed to in 1985. Due to limited import competition from more efficient foreign suppliers, the prices of machine tools in the United States rose to higher levels than would have prevailed under free trade. Because machine tools are used throughout the manufacturing industry, the result was to increase the costs of U.S. manufacturing in general, creating a corresponding loss in world market competitiveness. Shielded from international competition by import barriers, the U.S. machine tool industry had no incentive to increase its efficiency. Consequently, it lost many of its export markets to more efficient foreign competitors. Because of this misguided action, the U.S. machine tool industry shrunk during the period when the agreement was in force. For anyone schooled in international trade theory, this was not surprising.[40] A similar scenario unfolded in the U.S. steel industry, where tariff barriers erected by the government in the early 2000s raised the cost of steel to important U.S. users, such as automobile companies and appliance makers, making their products more uncompetitive.

Finally, Porter's theory of national competitive advantage also contains policy implications. Porter's theory suggests that it is in the best interest of business for a firm to invest in upgrading advanced factors of production, for example, to invest in better training for its employees and to increase its commitment to research and development. It is also in the best interests of business to lobby the government to adopt policies that have a favorable impact on each component of the national diamond. Thus, according to Porter, businesses should urge government to increase investment in education, infrastructure, and basic research (since all these enhance advanced factors) and to adopt policies that promote strong competition within domestic markets (since this makes firms stronger international competitors, according to Porter's findings).

CHAPTER SUMMARY

This chapter reviewed a number of theories that explain why it is beneficial for a country to engage in international trade and explained the pattern of international trade observed in the world economy. The theories of Smith, Ricardo, and Heckscher-Ohlin all make strong cases for unrestricted free trade. In contrast, the mercantilist doctrine and, to a lesser extent, the new trade theory can be interpreted to support government intervention to promote exports through subsidies and to limit imports through tariffs and quotas.

In explaining the pattern of international trade, this chapter shows that, with the exception of mercantilism, which is silent on this issue, the different theories offer largely complementary explanations. Although no one theory may explain the apparent pattern of international trade, taken together, the theory of comparative advantage, the Heckscher-Ohlin theory, the product life-cycle theory, the new trade theory, and Porter's theory of national competitive advantage do suggest which factors are important. Comparative advantage tells us that productivity differences are important; Heckscher-Ohlin tells us that factor endowments matter; the product life-cycle theory tells us that where a new product is introduced is important; the new trade theory tells us that increasing returns to specialization and first-mover advantages matter; and Porter tells us that all these factors may be important insofar as they impact the four components of the national diamond. The chapter made the following points:

1. Mercantilists argued that it was in a country's best interests to run a balance-of-trade surplus. They viewed trade as a zero-sum game, in which one country's gains cause losses for other countries.
2. The theory of absolute advantage suggests that countries differ in their ability to produce goods efficiently. The theory suggests that a country should specialize in producing goods in areas where it has an absolute advantage and import goods in areas where other countries have absolute advantages.
3. The theory of comparative advantage suggests that it makes sense for a country to specialize in producing those goods that it can produce most efficiently, while buying goods that it can produce relatively less efficiently from other countries—even if that means buying goods from other countries that it could produce more efficiently itself.
4. The theory of comparative advantage suggests that unrestricted free trade brings about increased world production, that is, that trade is a positive-sum game.
5. The theory of comparative advantage also suggests that opening a country to free trade stimulates economic growth, which creates dynamic gains from trade. The empirical evidence seems to be consistent with this claim.
6. The Heckscher-Ohlin theory argues that the pattern of international trade is determined by differences in factor endowments. It predicts that countries will export those goods that make intensive use of locally abundant factors and will import goods that make intensive use of factors that are locally scarce.
7. The product life-cycle theory suggests that trade patterns are influenced by where a new product is introduced. In an increasingly integrated global economy, the product life-cycle theory seems to be less predictive than it once was.
8. New trade theory states that trade allows a nation to specialize in the production of certain goods, attaining scale economies and lowering the costs of producing those goods, while buying goods that it does not produce from other nations that are similarly specialized. By this mechanism, the variety of goods available to consumers in each nation is increased, while the average costs of those goods should fall.
9. New trade theory also states that in those industries where substantial economies of scale imply that the world market will profitably support only a few firms, countries may predominate in the export of certain products simply because they had a firm that was a first mover in that industry.
10. Some new trade theorists have promoted the idea of strategic trade policy. The argument is that government, by the sophisticated and judicious use of subsidies, might be able to increase the chances of domestic firms becoming first movers in newly emerging industries.
11. Porter's theory of national competitive advantage suggests that the pattern of trade is influenced by four attributes of a nation: *(a)* factor endowments, *(b)* domestic demand conditions, *(c)* relating and supporting industries, and *(d)* firm strategy, structure, and rivalry.

12. Theories of international trade are important to an individual business firm primarily because they can help the firm decide where to locate its various production activities.
13. Firms involved in international trade can and do exert a strong influence on government policy toward trade. By lobbying government, business firms can promote free trade or trade restrictions.

Critical Thinking and Discussion Questions

1. Mercantilism is a bankrupt theory that has no place in the modern world. Discuss.
2. Is free trade fair? Discuss!
3. Unions in developed nations often oppose imports from low-wage countries and advocate trade barriers to protect jobs from what they often characterize as "unfair" import competition. Is such competition "unfair"? Do you think that this argument is in the best interests of (*a*) the unions, (*b*) the people they represent, and/or (*c*) the country as a whole?
4. What are the potential costs of adopting a free trade regime? Do you think governments should do anything to reduce these costs? What?
5. Reread the Country Focus "Is China a Neo-Mercantilist Nation?"
   a. Do you think China is pursing an economic policy that can be characterized as neo-mercantilist?
   b. What should the United States, and other countries, do about this?
6. Reread the Country Focus on moving white-collar jobs offshore.
   a. Who benefits from the outsourcing of skilled white-collar jobs to developing nations? Who are the losers?
   b. Will developing nations like the United States suffer from the loss of high-skilled and high-paying jobs?
   c. Is there a difference between the transference of high-paying white-collar jobs, such as computer programming and accounting, to developing nations, and low-paying blue-collar jobs? If so, what is the difference, and should government do anything to stop the flow of white-collar jobs out of the country to countries such as India?
7. Drawing upon the new trade theory and Porter's theory of national competitive advantage, outline the case for government policies that would build national competitive advantage in biotechnology. What kinds of policies would you recommend that the government adopt? Are these policies at variance with the basic free trade philosophy?
8. The world's poorest countries are at a competitive disadvantage in every sector of their economies. They have little to export. They have no capital; their land is of poor quality; they often have too many people given available work opportunities; and they are poorly educated. Free trade cannot possibly be in the interests of such nations. Discuss.

Research Task globalEDGE globaledge.msu.edu

International Trade Theory

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The *WTO's International Trade Statistics* is an annual report that provides comprehensive, comparable, and updated statistics on trade in merchandise and commercial services. This report allows for an assessment of world trade flows by country, region, and main product or service categories. Using the most recent statistics available, identify the top five countries that lead in the export and import of merchandise, respectively.

Exercise 2

Food is an integral part of understanding different countries, cultures, and lifestyles. In fact, your company is interested in importing Australian wine to the United States. However, you must first identify which *Australian suppliers* can provide specific types of wine for your burgeoning dinner cruise business. After searching the supplier directory, use specific criteria to compare the profiles of companies supplying both red and white. Decide which supplier is best for your company. Be sure to justify your conclusion.

CLOSING CASE

The Rise of Bangladesh's Textile Trade

Bangladesh, one of the world's poorest countries, has long depended heavily upon exports of textile products to generate income, employment, and economic growth. Most of these exports are low-cost finished garments sold to mass-market retailers in the West, such as Walmart. For decades, Bangladesh was able to take advantage of a quota system for textile exports that gave it, and other poor countries, preferential access to rich markets such as the United States and the European Union. On January 1, 2005, however, that system was scrapped in favor of one that was based on free trade principles. From then on, exporters in Bangladesh would have to compete for business against producers from other nations such as China and Indonesia. Many analysts predicted the quick collapse of Bangladesh's textile industry. They predicted a sharp jump in unemployment, a decline in the country's balance of payments accounts, and a negative impact on economic growth.

The collapse didn't happen. Bangladesh's exports of textiles continued to grow, even as the rest of the world plunged into an economic crisis in 2008. Bangladesh's exports of garments rose to $10.7 billion in 2008, up from $9.3 billion in 2007 and $8.9 billion in 2006. Apparently, Bangladesh has an advantage in the production of textiles—it is one of the world's low-cost producers—and this is allowing the country to grow its share of world markets. As a deep economic recession took hold in developed nations during 2008–09, big importers such as Walmart increased their purchases of low-cost garments from Bangladesh to better serve their customers, who were looking for low prices. Li & Fung, a Hong Kong company that handles sourcing and apparel manufacturing, stated its production in Bangladesh jumped percent in 2009, while production in China, its biggest supplier, slid 5 percent.

Bangladesh's advantage is based on a number of factors. First, labor costs are low, in part due to low hourly wage rates and in part due to investments by textile manufacturers in productivity-boosting technology during the past decade. Today, wage rates in the textile industry in Bangladesh are about $50 to $60 a month, less than half the minimum wage in China. While this pay rate seems dismally low by Western standards, in a country where the gross national income per capita is only $470 a year, it is a living wage and a source of employment for some 3 million people, 85 percent of whom are women with few alternative employment opportunities.

Another source of advantage for Bangladesh is that it has a vibrant network of supporting industries that supply inputs to its garment manufacturers. Some three-quarters of all inputs are made locally. This saves garment manufacturers transport and storage costs, import duties, and the long lead times that come with the imported woven fabrics used to make shirts and trousers. In other words, the local supporting industries help to boost the productivity of Bangladesh's garment manufacturers, giving them a cost advantage that goes beyond low wage rates.

Bangladesh also has the advantage of not being China! Many importers in the West have grown cautious about becoming too dependent upon China for imports of specific goods for fear that if there was disruption, economic or other, their supply chains would be decimated unless they had an alternative source of supply. Thus, Bangladesh has benefited from the trend by Western importers to diversify their supply sources. Although China remains the world's largest exporter of garments, with exports of $120 billion in 2008, wage rates are rising quite fast, suggesting the trend to shift textile production away from China may continue. Bangladesh, however, does have some negatives; most notable are the constant disruptions in electricity because the government has underinvested in power generation and distribution infrastructure. Roads and ports are also inferior to those found in China.[41]

Case Discussion Questions

1. Why was the shift to a free trade regime in the textile industry good for Bangladesh?
2. Who benefits when retailers in the United States source textiles from low-wage countries such as Bangladesh? Who might lose? Do the gains outweigh the losses?
3. What international trade theory, or theories, best explain the rise of Bangladesh as a textile exporting powerhouse?
4. How secure is Bangladesh's textile industry from foreign competition? What factors could ultimately lead to a decline?

Appendix: International Trade and the Balance of Payments

International trade involves the sale of goods and services to residents in other countries (exports) and the purchase of goods and services from residents in other countries (imports). A country's **balance-of-payments accounts** keep track of the payments to and receipts from other countries for a particular time period. These include payments to foreigners for imports of goods and service, and receipts from foreigners for goods and services exported to them. A summary copy of the U.S. balance-of-payments accounts for 2010 is given in Table A.1. Any transaction resulting in a payment to other countries is entered in the balance-of-payments accounts as a debit and given a negative (–) sign. Any transaction resulting in a receipt from other countries is entered as a credit and given a positive (+) sign. In this appendix we briefly describe the form of the balance-of-payments accounts, and we discuss whether a current account deficit, often a cause of much concern in the popular press, is something to worry about.

Balance-of-Payments Accounts

Balance-of-payments accounts are divided into three main sections: the current account, the capital account, and the financial account (to confuse matters, what is now called the *capital account* was until recently part of the current account, and the financial account used to be called the capital account). The **current account** records transactions that pertain to three categories, all of which can be seen in Table A.1. The first category, *goods*, refers to the export or import of physical goods (e.g., agricultural foodstuffs, autos, computers, chemicals). The second category is the export or import of *services* (e.g., intangible products such as banking and insurance services). The third category, *income receipts and payments*, refers to income from foreign investments and payments that have to be made to foreigners investing in a country. For example, if a U.S. citizen owns a share of a Finnish company and receives a dividend payment of $5, that payment shows up on the U.S. current account as the receipt of $5 of investment income. Also included in the current account are unilateral current transfers, such as U.S. government grants to foreigners (including foreign aid) and private payments to foreigners (such as when a foreign worker in the United States sends money to his or her home country).

A **current account deficit** occurs when a country imports more goods, services, and income than it exports. A **current account surplus** occurs when a country exports more goods, services, and income than it imports. Table A.1 shows that in 2010 the United States ran a current account deficit of $378.4 billion. This is often a headline-grabbing figure and is widely reported in the news media. In recent years the U.S. current account deficit has been quite large, primarily because America imports far more physical goods than it exports. (The United States typically runs a surplus on trade in services and is close to balance on income payments.)

The 2006 current account deficit of $803 billion was the largest on record and was equivalent to about 6.5 percent of the country's GDP. The deficit has shrunk since then, in response to the economic crisis and prolonged recession of 2008–2009 as much as anything else. Many people find these figures disturbing, the common assumption being that high imports of goods displaces domestic production, causes unemployment, and reduces the growth of the U.S. economy. For example, *The New York Times* responded to the record current account deficit in 2006 by stating:

> A growing trade deficit acts as a drag on overall economic growth. Economists said that they expect that, in light of the new numbers, the government will have to revise its estimate of the nation's fourth quarter gross domestic product to show slightly slower expansion.[42]

However, the issue is somewhat more complex than implied by statements like this. Fully understanding the implications of a large and persistent deficit requires that we look at the rest of the balance-of-payments accounts.

The **capital account** records one-time changes in the stock of assets. As noted above, until recently this item was included in the current account. The capital account includes capital transfers, such as debt forgiveness and migrants' transfers (the goods and financial assets that accompany migrants as they enter or leave the country). In the big scheme of things this is a relatively small figure amounting to –$140 million in 2010.

The **financial account** (formerly the capital account) records transactions that involve the purchase or sale of assets. Thus, when a German firm purchases stock in a U.S. company or buys a U.S. bond, the transaction enters the U.S. balance of payments as a credit on the capital account. This is because capital is flowing into the country. When capital flows out of the United States, it enters the capital account as a debit.

The financial account is comprised of a number of elements. The net change in U.S.-owned assets abroad includes the change in assets owned by the U.S. government (U.S. official reserve assets and U.S. government assets), and the change in assets owned by private

TABLE A.1

U.S. Balance-of-Payments Accounts, 2010 ($ millions)

Source: Bureau of Economic Analysis.

Current Account	$ Millions
Exports of Goods, Services, and Income Receipts	2,159,233
Goods	1,068,499
Services	502,298
Income Receipts	588,203
Imports of Goods, Services, and Income Payments	–2,412,489
Goods	–1,945,705
Services	–1,575,443
Income Payments	–466,783
Unilateral Current Transfers (net)	–124,943
Current Account Balance	–378,432
CAPITAL ACCOUNT	
Capital Account Transactions (net)	–140
FINANCIAL ACCOUNT	
U.S.-Owned Assets Abroad, net	–140,465
U.S. Official Reserve Assets	–52,256
U.S. Government Assets	–541,342
U.S. Private Assets	–629,552
Foreign-Owned Assets in the United States	305,736
Foreign Official Assets in the United States	450,030
Other Foreign Assets in the United States	–144,294
Statistical Discrepancy	162,497

individuals and corporations. As can be seen from Table A.1, in 2010 there was a –$140,465 million reduction in U.S. assets owned abroad due to a fall in the amount of foreign assets owned by the U.S. government and private individuals and corporations. In other words, these entities were selling off foreign assets, such as foreign bonds and currencies, during 2010.

Also included in the financial account are foreign-owned assets in the United States. These are divided into assets owned by foreign governments (foreign official assets) and assets owned by other foreign entities such as corporations and individuals (other foreign assets in the United States). As can be seen, in 2010 foreigners increased their holdings of U.S. assets, including treasury bills, corporate stocks and bonds, and direct investments in the United States, by $306 billion. Some $450 billion of this was due to an increase in the holding of U.S. assets by foreign governments, while foreign private corporations and individuals reduced their holdings of U.S. assets by $144 billion.

A basic principle of balance-of-payments accounting is double-entry bookkeeping. Every international transaction automatically enters the balance of payments twice—once as a credit and once as a debit. Imagine that you purchase a car produced in Japan by Toyota for $20,000. Since your purchase represents a payment to another country for goods, it will enter the balance of payments as a debit on the current account. Toyota now has the $20,000 and must do something with it. If Toyota deposits the money at a U.S. bank, Toyota has purchased a U.S. asset—a bank deposit worth $20,000—and the transaction will show up as a $20,000 credit on the financial account. Or Toyota might deposit the cash in a Japanese bank in return for Japanese yen. Now the Japanese bank must decide what to do with the $20,000. Any action that it takes will ultimately result in a credit for the U.S. balance of payments. For example, if the bank lends the $20,000 to a Japanese firm that uses it to import personal computers from the United States, then the $20,000 must be credited to the U.S. balance-of-payments current account. Or the Japanese bank might use the $20,000 to purchase U.S. government bonds, in which case it will show up as a credit on the U.S. balance-of-payments financial account.

Thus, any international transaction automatically gives rise to two offsetting entries in the balance of payments. Because of this, *the sum of the current account balance, the capital account, and the financial account balance*

should always add up to zero. In practice, this does not always occur due to the existence of "statistical discrepancies," the source of which need not concern us here (note that in 2010 the statistical discrepancy amounted to $162 billion).

Does the Current Account Deficit Matter?

As discussed above, there is some concern when a country is running a deficit on the current account of its balance of payments.[43] In recent years a number of rich countries, including most notably the United States, have run persistent and growing current account deficits. When a country runs a current account deficit, the money that flows to other countries can then be used by those countries to purchase assets in the deficit country. Thus, when the United States runs a trade deficit with China, the Chinese use the money that they receive from U.S. consumers to purchase U.S. assets such as stocks, bonds, and the like. Put another way, a deficit on the current account is financed by selling assets to other countries; that is, by a surplus on the financial account. Thus, the persistent U.S. current account deficit is being financed by a steady sale of U.S. assets (stocks, bonds, real estate, and whole corporations) to other countries. In short, countries that run current account deficits become net debtors.

For example, as a result of financing its current account deficit through asset sales, the United States must deliver a stream of interest payments to foreign bondholders, rents to foreign landowners, and dividends to foreign stockholders. One might argue that such payments to foreigners drain resources from a country and limit the funds available for investment within the country. Since investment within a country is necessary to stimulate economic growth, a persistent current account deficit can choke off a country's future economic growth. This is the basis of the argument that persistent deficits are bad for an economy.

However, things are not this simple. For one thing, in an era of global capital markets money is efficiently directed toward its highest value uses, and over the past quarter of a century many of the highest value uses of capital have been in the United States. So even though capital is flowing out of the United States in the form of payments to foreigners, much of that capital finds its way right back into the country to fund productive investments in the United States. In short, it is not clear that the current account deficit chokes off U.S. economic growth. In fact, notwithstanding the 2008–2009 recession, the U.S. economy has grown substantially over the past 25 years, despite running a persistent current account deficit, and despite financing that deficit by selling U.S. assets to foreigners. This is precisely because foreigners reinvest much of the income earned from U.S. assets, and from exports to the United States, right back into the United States. This revisionist view, which has gained in popularity in recent years, suggests that a persistent current account deficit might not be the drag on economic growth it was once thought to be.[44]

Having said this, there is still a nagging fear that at some point the appetite that foreigners have for U.S. assets might decline. If foreigners suddenly reduced their investments in the United States, what would happen? In short, instead of reinvesting the dollars that they earn from exports and investment in the United States back into the country, they would sell those dollars for another currency, European euros, Japanese yen, or Chinese yuan, for example, and invest in euro-, yen-, and yuan-denominated assets instead. This would lead to a fall in the value of the dollar on foreign exchange markets, and that in turn would increase the price of imports, and lower the price of U.S. exports, making them more competitive, which should reduce the overall level of the current account deficit. Thus, in the long run, the persistent U.S. current account deficit could be corrected via a reduction in the value of the U.S. dollar. The concern is that such adjustments may not be smooth. Rather than a controlled decline in the value of the dollar, the dollar might suddenly lose a significant amount of its value in a very short time, precipitating a "dollar crisis."[45] Since the U.S. dollar is the world's major reserve currency, and is held by many foreign governments and banks, any dollar crisis could deliver a body blow to the world economy and at the very least trigger a global economic slowdown. That would not be a good thing.

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7 The Political Economy of International Trade

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Identify the policy instruments used by governments to influence international trade flows.
- **LO2** Understand why governments sometimes intervene in international trade.
- **LO3** Summarize and explain the arguments against strategic trade policy.
- **LO4** Describe the development of the world trading system and the current trade issue.
- **LO5** Explain the implications for managers of developments in the world trading system.

U.S. Tariffs on Tier Imports from China

In September 2009 President Obama placed a tariff on imports of tires from China. The tariff was a response to a rising tide of imports from China and intense lobbying from the United Steelworkers union, which represents 15,000 workers at 13 tire plants in the United States. Tires imported from China are usually low-end models that sell for half the price of American-made name-brand tires. In 2008, the United States imported 46 million tires from China, three times as many as it did in 2004. China's share of the American market leaped from 5 percent to almost 17 percent over the same period, while U.S. employment in the industry fell by more than 5,000 and domestic production slumped from 218 million tires to 160 million tires.

The United Steelworkers had petitioned the International Trade Commission, which is a unit of the U.S. Department of Commerce, for protection. After reviewing the case, the commission concluded that the surge in Chinese tire imports was causing significant "market disruption" and recommended imposing a three-year tariff on Chinese imports of tires. The Obama administration agreed and placed a 35 percent tariff for one year on tire imports from China, followed by a 30 percent tariff in the second year and a 25 percent tariff in the final year. These tariffs were placed upon top of an existing 4 percent import tariff.

The Chinese quickly objected, calling the tariffs "a serious case of protectionism" and arguing that the United States was violating World Trade Organization (WTO)



rules, of which both countries were members. For its part, the United States argued that the tariffs were allowed for under the terms of a special safeguard provision that was part of the U.S. agreement to support China's entry into the WTO in 2001. Under that provision, U.S. companies or workers harmed by imports from China can ask the government for protection simply by demonstrating that American producers have suffered a "market disruption" or have experienced a surge in imports from China.

The WTO's dispute resolution panel quickly took on the case. In December 2010 the panel issued its ruling, finding that the United States "did not fail to comply with its obligations" under world trade agreements, and allowing the tariffs to remain. China immediately appealed the ruling. Chinese officials stated the tariff has hurt the interests of both China and the United States. They argued that the tariffs cost jobs in the U.S. sales sector, causing some small and medium-size wholesalers and dealers to go out of business. Moreover, they argued that the tariff has burdened low-income consumers in the United States, with the average price of tires increasing 10 to 20 percent since the tariffs were imposed. For its part, the United Steelworkers argued that the tariff had been a big success. For the first six months after the tariffs were imposed, U.S. production increased more than 15 percent, and U.S. producers were making plans to add additional capacity. During the same period, tire imports from China fell by 34 percent.[1]

Introduction

The review of the classical trade theories of Smith, Ricardo, and Heckscher-Ohlin in Chapter 6 showed that in a world without trade barriers, trade patterns are determined by the relative productivity of different factors of production in different countries. Countries will specialize in products that they can make most efficiently, while importing products that they can produce less efficiently. Chapter 6 also laid out the intellectual case for free trade. Remember, **free trade** refers to a situation in which a government does not attempt to restrict what its citizens can buy from or sell to another country. As we saw in Chapter 6, the theories of Smith, Ricardo, and Heckscher-Ohlin predict that the consequences of free trade include both static economic gains (because free trade supports a higher level of domestic consumption and more efficient utilization of resources) and dynamic economic gains (because free trade stimulates economic growth and the creation of wealth).

This chapter looks at the political reality of international trade. Although many nations are nominally committed to free trade, they tend to intervene in international trade to protect the interests of politically important groups or promote the interests of key domestic producers. The opening case illustrates one such situation. In late 2009 the Obama administration placed a three-year tariff on tire imports from China. The tariff was designed to protect American producers from low-cost Chinese imports, thereby helping to create jobs in the U.S. tire industry. However, it may also have raised the average price of tires to American consumers, leaving them with less money to spend on other goods and services. For its part, the Obama administration clearly believes that the gains, in terms of jobs saved or created, outweigh any losses from higher prices. The Chinese clearly hold a different view. The World Trade Organization (WTO), which both nations belong to, has had to adjudicate this case. So far it has supported the American position (at the time of this writing, the case is still ongoing with an appeal in progress). In most cases like this, the WTO would probably have ruled against the United States. However, the United States extracted major concessions from China as part of its agreement to support the Chinese entry into the WTO in 2001. Under the terms of these concessions, the United States has the ability to impose such temporary tariffs (see the case for details). The interesting question is what will happen once the tariffs expire. Will Chinese imports surge again, in which case what was the point of the tariff, or will U.S. producers have improved their position sufficiently to hold on to market share?

This chapter explores the political and economic reasons that governments have for intervening in international trade. When governments intervene, they often do so by restricting imports of goods and services into their nation, while adopting policies that promote domestic production and exports. Normally their motives are to protect domestic producers. In recent years, social issues have intruded into the decision-making calculus. In the United States, for example, a movement is growing to ban imports of goods from countries that do not abide by the same labor, health, and environmental regulations as the United States.

This chapter starts by describing the range of policy instruments that governments use to intervene in international trade. A detailed review of governments' various political and economic motives for intervention follows. In the third section of this chapter, we consider how the case for free trade stands up in view of the various justifications given for government intervention in international trade. Then we look at the emergence of the modern international trading system, which is based on the General Agreement on Tariffs and Trade and its successor, the WTO. The GATT and WTO are the creations of a series of multinational treaties. The most recent was completed in 1995, involved more than 120 countries, and resulted in the creation of the WTO. The purpose of these treaties has been to lower barriers to the free flow of goods and services between nations. Like the GATT before it, the WTO promotes free trade by limiting the ability of national governments to adopt policies that restrict imports into their nations. The final section of this chapter discusses the implications of this material for management practice.

Instruments of Trade Policy LO1

Trade policy uses seven main instruments: tariffs, subsidies, import quotas, voluntary export restraints, local content requirements, administrative policies, and antidumping duties. Tariffs are the oldest and simplest instrument of trade policy. As we shall see later in this chapter, they are also the instrument that the GATT and WTO have been most successful in limiting. A fall in tariff barriers in recent decades has been accompanied by a rise in nontariff barriers, such as subsidies, quotas, voluntary export restraints, and antidumping duties.

TARIFFS

A **tariff** is a tax levied on imports (or exports). Tariffs fall into two categories. **Specific tariffs** are levied as a fixed charge for each unit of a good imported (for example, $3 per barrel of oil). **Ad valorem tariffs** are levied as a proportion of the value of the imported good. In most cases, tariffs are placed on imports to protect domestic producers from foreign competition by raising the price of imported goods. However, tariffs also produce revenue for the government. Until the income tax was introduced, for example, the U.S. government received most of its revenues from tariffs.

The important thing to understand about an import tariff is who suffers and who gains. The government gains, because the tariff increases government revenues. Domestic producers gain, because the tariff affords them some protection against foreign competitors by increasing the cost of imported foreign goods. Consumers lose because they must pay more for certain imports. For example, in 2002 the U.S. government placed an ad valorem tariff of 8 percent to 30 percent on imports of foreign steel. The idea was to protect domestic steel producers from cheap imports of foreign steel. The effect, however, was to raise the price of steel products in the United States between 30 and 50 percent. A number of U.S. steel consumers, ranging from appliance makers to automobile companies, objected that the steel tariffs would raise their costs of production and make it more difficult for them to compete in the global marketplace. Whether the gains to the government and domestic producers exceed the loss to consumers depends on various factors such as the amount of the tariff, the importance of the imported good to domestic consumers, the number of jobs saved in the protected industry, and so on. In the steel case, many argued that the losses to steel consumers apparently outweighed the gains to steel producers. In November 2003, the World Trade Organization declared that the tariffs represented a violation of the WTO treaty, and the United States removed them in December of that year.

In general, two conclusions can be derived from economic analysis of the effect of import tariffs.[2] First, tariffs are generally pro-producer and anti-consumer. While they protect producers from foreign competitors, this restriction of supply also raises domestic prices. For example, a study by Japanese economists calculated that tariffs on imports of foodstuffs, cosmetics, and chemicals into Japan cost the average Japanese consumer about $890 per year in the form of higher prices.[3] Similarly, the opening case suggests that prices for tires in the United States rose by 10 to 20 percent after the Obama administration placed a high tariff on tire imports from China. Almost all studies find that import tariffs impose significant costs on domestic consumers in the form of higher prices.[4]

Second, import tariffs reduce the overall efficiency of the world economy. They reduce efficiency because a protective tariff encourages domestic firms to produce products at home that, in theory, could be produced more efficiently abroad. The consequence is an inefficient utilization of resources. For example, tariffs on the importation of rice into South Korea have led to an increase in rice production in that country; however, rice farming is an unproductive use of land in South Korea. It would make more sense for the South Koreans to purchase their rice from lower-cost foreign producers and to utilize the land now employed in rice production in some other way, such as growing foodstuffs

that cannot be produced more efficiently elsewhere or for residential and industrial purposes.

Sometimes tariffs are levied on exports of a product from a country. Export tariffs are far less common than import tariffs. In general, export tariffs have two objectives: first, to raise revenue for the government, and second, to reduce exports from a sector, often for political reasons. For example, in 2004 China imposed a tariff on textile exports. The primary objective was to moderate the growth in exports of textiles from China, thereby alleviating tensions with other trading partners.

SUBSIDIES

A **subsidy** is a government payment to a domestic producer. Subsidies take many forms, including cash grants, low-interest loans, tax breaks, and government equity participation in domestic firms. By lowering production costs, subsidies help domestic producers in two ways: (1) competing against foreign imports and (2) gaining export markets. According to the World Trade Organization, in the mid-2000s countries spent some $300 billion on subsidies, $250 billion of which was spent by 21 developed nations.[5] In response to a severe sales slump following the global financial crisis, between mid-2008 and mid-2009 some developed nations gave $45 billion in subsidies to their automobile makers. While the purpose of the subsidies was to help them survive a very difficult economic climate, one of the consequences was to give subsidized companies an unfair competitive advantage in the global auto industry.

Agriculture tends to be one of the largest beneficiaries of subsidies in most countries. In the mid-2000s, the European Union was paying about €44 billion annually ($55 billion) in farm subsidies. Not to be outdone, in May 2002 President George W. Bush signed into law a bill that contained subsidies of more than $180 billion for U.S. farmers spread over 10 years. This was followed in 2007 by a farm bill that contained $286 billion in subsidies for the next 10 years. The Japanese also have a long history of supporting inefficient domestic producers with farm subsidies. The accompanying Country Focus looks at subsidies to wheat producers in Japan.

Nonagricultural subsidies are much lower, but they are still significant. For example, subsidies historically were given to Boeing and Airbus to help them lower the cost of developing new commercial jet aircraft. In Boeing's case, subsides came in the form of tax credits for R&D spending or Pentagon money that was used to develop military technology, which then was transferred to civil aviation projects. In the case of Airbus, subsidies took the form of government loans at below-market interest rates.

The main gains from subsidies accrue to domestic producers, whose international competitiveness is increased as a result. Advocates of strategic trade policy (which, as you will recall from Chapter 6, is an outgrowth of the new trade theory) favor subsidies to help domestic firms achieve a dominant position in those industries in which economies of scale are important and the world market is not large enough to profitably support more than a few firms (aerospace and semiconductors are two such industries). According to this argument, subsidies can help a firm achieve a first-mover advantage in an emerging industry (just as U.S. government subsidies, in the form of substantial R&D grants, allegedly helped Boeing). If this is achieved, further gains to the domestic economy arise from the employment and tax revenues that a major global company can generate. However, government subsidies must be paid for, typically by taxing individuals and corporations.

Whether subsidies generate national benefits that exceed their national costs is debatable. In practice, many subsidies are not that successful at increasing the international competitiveness of domestic producers. Rather, they tend to protect the inefficient and promote excess production. One study estimated that if advanced countries abandoned subsidies to farmers, global trade in agricultural products would be 50 percent higher and the world as a whole would be better off by $160 billion.[6] Another study estimated that removing all barriers to trade in agriculture (both subsidies and tariffs)



COUNTRY FOCUS

Subsidized Wheat Production in Japan

Japan is not a particularly good environment for growing wheat. Wheat produced on large fields in the dry climates of North America, Australia, and Argentina is far cheaper and of much higher quality than anything produced in Japan. Indeed, Japan imports some 80 percent of its wheat from foreign producers. Yet tens of thousands of farmers in Japan still grow wheat, usually on small fields where yields are low and costs high, and production is rising. The reason is government subsidies designed to keep inefficient Japanese wheat producers in business. In the mid-2000s, Japanese farmers were selling their output at market prices, which were running at $9 per bushel, but they received an average of at least $35 per bushel for their production! The difference—$26 a bushel— was government subsidies paid to producers. The estimated costs of these subsidies were more than $700 million a year.

To finance its production subsidy, Japan operates a tariff rate quota on wheat imports in which a higher tariff rate is imposed once wheat imports exceed the quota level. The in-quota rate tariff is zero, while the over-quota tariff rate for wheat is $500 a ton. The tariff raises the cost so much that it deters over-quota imports, essentially restricting supply and raising the price for wheat inside Japan. The Japanese Ministry of Agriculture, Forestry, and Fisheries (MAFF) has the sole right to purchase wheat imports within the quota (and because there are very few over-quota imports, the MAFF is a monopoly buyer on wheat imports into Japan). The MAFF buys wheat at world prices and then resells it to millers in Japan at the artificially high prices that arise due to the restriction on supply engineered by the tariff rate quota. Estimates suggest that in 2004, the world market price for wheat was $5.96 per bushel, but within Japan the average price for imported wheat was $10.23 a bushel. The markup of $4.27 a bushel yielded the MAFF in excess of $450 million in profit. This "profit" was then used to help cover the $700 million cost of subsidies to inefficient wheat farmers, with the rest of the funds coming from general government tax revenues.

Thanks to these policies, the price of wheat in Japan can be anything from 80 to 120 percent higher than the world price, and Japanese wheat production, which exceeded 850,000 tons in 2004, is significantly greater than it would be if a free market was allowed to operate. Indeed, under free market conditions, there would be virtually no wheat production in Japan because the costs of production are simply too high. The beneficiaries of this policy are the thousands of small farmers in Japan who grow wheat. The losers include Japanese consumers, who must pay more for products containing wheat and who must finance wheat subsidies through taxes, and foreign producers, who are denied access to a chunk of the Japanese market by the over-quota tariff rate. Why then does the Japanese government continue to pursue this policy? It continues because small farmers are an important constituency and Japanese politicians want their votes.[8]

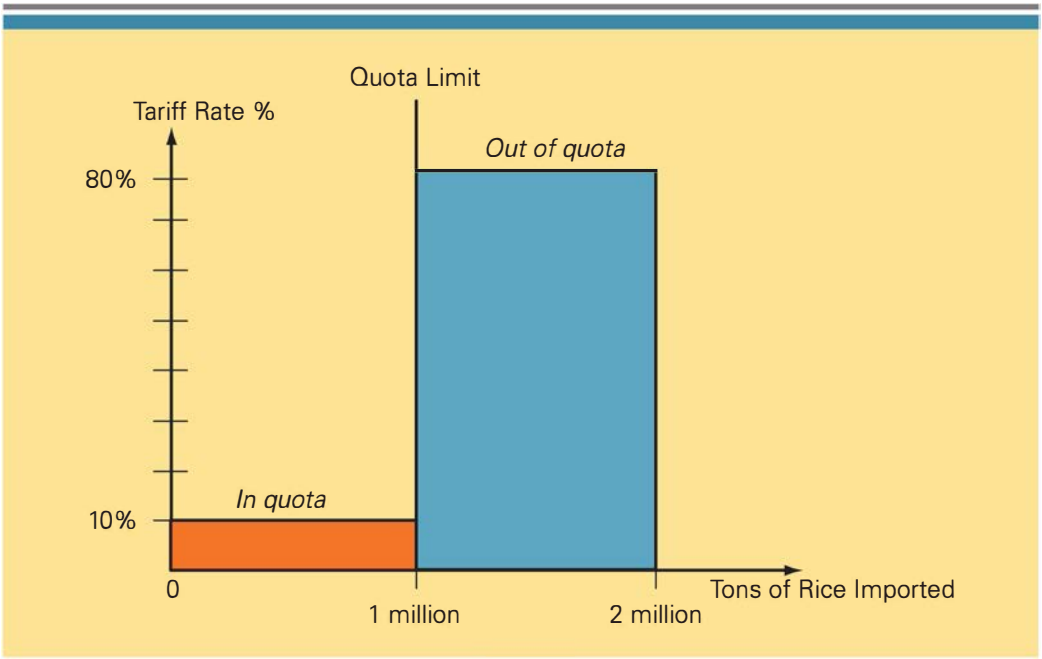
would raise world income by $182 billion.[7] This increase in wealth arises from the more efficient use of agricultural land. For a specific example, see the Country Focus on wheat subsidies in Japan.

IMPORT QUOTAS AND VOLUNTARY EXPORT RESTRAINTS

An **import quota** is a direct restriction on the quantity of some good that may be imported into a country. The restriction is usually enforced by issuing import licenses to a group of individuals or firms. For example, the United States has a quota on cheese imports. The only firms allowed to import cheese are certain trading companies, each of which is allocated the right to import a maximum number of pounds of cheese each year. In some cases, the right to sell is given directly to the governments of exporting countries. Historically this is the case for sugar and textile imports in the United States.

FIGURE 7.1

Hypothetical Tariff Rate Quota



However, the international agreement governing the imposition of import quotas on textiles, the Multi-Fiber Agreement, expired in December 2004.

A common hybrid of a quota and a tariff is known as a tariff rate quota. Under a **tariff rate quota**, a lower tariff rate is applied to imports within the quota than those over the quota. For example, as illustrated in Figure 7.1, an ad valorem tariff rate of 10 percent might be levied on 1 million tons of rice imports into South Korea, after which an out-of-quota rate of 80 percent might be applied. Thus, South Korea might import 2 million tons of rice, 1 million at a 10 percent tariff rate and another 1 million at an 80 percent tariff. Tariff rate quotas are common in agriculture, where their goal is to limit imports over quota. An example is given in the Country Focus that looks at how Japan uses the combination of a tariff rate quota and subsidies to protect inefficient Japanese wheat farmers from foreign competition.

A variant on the import quota is the voluntary export restraint. A **voluntary export restraint (VER)** is a quota on trade imposed by the exporting country, typically at the request of the importing country's government. One of the most famous historical examples is the limitation on auto exports to the United States enforced by Japanese automobile producers in 1981. A response to direct pressure from the U.S. government, this VER limited Japanese imports to no more than 1.68 million vehicles per year. The agreement was revised in 1984 to allow 1.85 million Japanese vehicles per year. The agreement was allowed to lapse in 1985, but the Japanese government indicated its intentions at that time to continue to restrict exports to the United States to 1.85 million vehicles per year.[9] Foreign producers agree to VERs because they fear more damaging punitive tariffs or import quotas might follow if they do not. Agreeing to a VER is seen as a way to make the best of a bad situation by appeasing protectionist pressures in a country.

As with tariffs and subsidies, both import quotas and VERs benefit domestic producers by limiting import competition. As with all restrictions on trade, quotas do not benefit consumers. An import quota or VER always raises the domestic price of an imported good. When imports are limited to a low percentage of the market by a quota or VER, the price is bid up for that limited foreign supply. The automobile industry VER mentioned above increased the price of the limited supply of Japanese imports. According to a study by the U.S. Federal Trade Commission, the automobile VER cost U.S. consumers about $1 billion per year between 1981 and 1985. That $1 billion per year went to Japanese producers in the form of higher prices.[10] The extra profit that producers make when supply is artificially limited by an import quota is referred to as a **quota rent**.

If a domestic industry lacks the capacity to meet demand, an import quota can raise prices for *both* the domestically produced and the imported good. This happened in the U.S. sugar industry, in which a tariff rate quota system has long limited the amount foreign producers can sell in the U.S. market. According to one study, import quotas have caused the price of sugar in the United States to be as much as 40 percent greater than the world price.[11] These higher prices have translated into greater profits for U.S. sugar producers, which have lobbied politicians to keep the lucrative agreement. They argue U.S. jobs in the sugar industry will be lost to foreign producers if the quota system is scrapped.

LOCAL CONTENT REQUIREMENTS

A **local content requirement** is a requirement that some specific fraction of a good be produced domestically. The requirement can be expressed either in physical terms (e.g., 75 percent of component parts for this product must be produced locally) or in value terms (e.g., 75 percent of the value of this product must be produced locally). Local content regulations have been widely used by developing countries to shift their manufacturing base from the simple assembly of products whose parts are manufactured elsewhere into the local manufacture of component parts. They have also been used in developed countries to try to protect local jobs and industry from foreign competition. For example, a little-known law in the United States, the Buy America Act, specifies that government agencies must give preference to American products when putting contracts for equipment out to bid unless the foreign products have a significant price advantage. The law specifies a product as "American" if 51 percent of the materials by value are produced domestically. This amounts to a local content requirement. If a foreign company, or an American one for that matter, wishes to win a contract from a U.S. government agency to provide some equipment, it must ensure that at least 51 percent of the product by value is manufactured in the United States.

Local content regulations provide protection for a domestic producer of parts in the same way an import quota does: by limiting foreign competition. The aggregate economic effects are also the same; domestic producers benefit, but the restrictions on imports raise the prices of imported components. In turn, higher prices for imported components are passed on to consumers of the final product in the form of higher final prices. So as with all trade policies, local content regulations tend to benefit producers and not consumers.

ADMINISTRATIVE POLICIES

In addition to the formal instruments of trade policy, governments of all types sometimes use informal or administrative policies to restrict imports and boost exports. **Administrative trade policies** are bureaucratic rules designed to make it difficult for imports to enter a country. It has been argued that the Japanese are the masters of this trade barrier. In recent decades Japan's formal tariff and nontariff barriers have been among the lowest in the world. However, critics charge that the country's informal administrative barriers to imports more than compensate for this. For example, at one point the Netherlands exported tulip bulbs to almost every country in the world except Japan. In Japan, customs inspectors insisted on checking every tulip bulb by cutting it vertically down the middle, and even Japanese ingenuity could not put them back together. Federal Express also initially had a tough time expanding its global express shipping services into Japan because Japanese customs inspectors insist on opening a large proportion of express packages to check for pornography, a process that delayed an "express" package for days. Japan is not the only country that engages in such policies. France once required that all imported videotape recorders arrive through a small customs entry point that was both remote and poorly staffed. The resulting delays kept Japanese VCRs out of the French market until a VER agreement was negotiated.[12] As with all instruments of trade policy, administrative instruments benefit producers and hurt consumers, who are denied access to possibly superior foreign products.



MANAGEMENT FOCUS

U.S. Magnesium Seeks Protection

In February 2004, U.S. Magnesium, the sole surviving U.S. producer of magnesium, a metal that is primarily used in the manufacture of certain automobile parts and aluminum cans, filed a petition with the U.S. International Trade Commission (ITC) contending that a surge in imports had caused material damage to the U.S. industry's employment, sales, market share, and profitability. According to U.S. Magnesium, Russian and Chinese producers had been selling the metal at prices significantly below market value. During 2002 and 2003, imports of magnesium into the United States rose 70 percent, while prices fell by 40 percent and the market share accounted for by imports jumped to 50 percent from 25 percent.

"The United States used to be the largest producer of magnesium in the world," a U.S. Magnesium spokesman said at the time of the filing. "What's really sad is that you can be state of the art and have modern technology, and if the Chinese, who pay people less than 90 cents an hour, want to run you out of business, they can do it. And that's why we are seeking relief."

During a yearlong investigation, the ITC solicited input from various sides in the dispute. Foreign producers and consumers of magnesium in the United States argued that falling prices for magnesium during 2002 and 2003 simply reflected an imbalance between supply and demand due to additional capacity coming on stream not from Russia or China but from a new Canadian plant that opened in 2001 and from a planned Australian plant. The Canadian plant shut down in 2003, the Australian plant never came on stream, and prices for magnesium rose again in 2004.

Magnesium consumers in the United States also argued to the ITC that imposing antidumping duties on foreign imports of magnesium would raise prices in the United States significantly above world levels. A spokesman for Alcoa, which mixes magnesium with aluminum to make alloys for cans, predicted that if antidumping duties were imposed, high magnesium prices in the United States would force Alcoa to move some production out of the United States. Alcoa also noted that in 2003, U.S. Magnesium was unable to supply all of Alcoa's needs, forcing the company to turn to imports. Consumers of magnesium in the automobile industry asserted that high prices in the United States would drive engineers to design magnesium out of automobiles, or force manufacturing elsewhere, which would ultimately hurt everyone.

The six members of the ITC were not convinced by these arguments. In March 2005, the ITC ruled that both China and Russia had been dumping magnesium in the United States. The government decided to impose duties ranging from 50 percent to more than 140 percent on imports of magnesium from China. Russian producers face duties ranging from 19 percent to 22 percent. The duties were to be levied for five years, after which the ITC would revisit the situation.

According to U.S. Magnesium, the favorable ruling would allow the company to reap the benefits of nearly $50 million in investments made in its manufacturing plant and enable the company to boost its capacity by 28 percent by the end of 2005. Commenting on the favorable ruling, a U.S. Magnesium spokesman noted, "Once unfair trade is removed from the marketplace we'll be able to compete with anyone." U.S. Magnesium's customers and competitors, however, did not view the situation in the 2002–2003 period as one of unfair trade. While the imposition of antidumping duties no doubt will help to protect U.S. Magnesium and the 400 people it employs from foreign competition, magnesium consumers in the United States are left wondering if they will be the ultimate losers.[13]

ANTIDUMPING POLICIES

In the context of international trade, **dumping** is variously defined as selling goods in a foreign market at below their costs of production or as selling goods in a foreign market at below their "fair" market value. There is a difference between these two definitions; the fair market value of a good is normally judged to be greater than the costs of producing that good because the former includes a "fair" profit margin. Dumping is viewed as a method by which firms unload excess production in foreign markets. Some dumping may

be the result of predatory behavior, with producers using substantial profits from their home markets to subsidize prices in a foreign market with a view to driving indigenous competitors out of that market. Once this has been achieved, so the argument goes, the predatory firm can raise prices and earn substantial profits.

An alleged example of dumping occurred in 1997, when two South Korean manufacturers of semiconductors, LG Semicon and Hyundai Electronics, were accused of selling dynamic random access memory chips (DRAMs) in the U.S. market at below their costs of production. This action occurred in the middle of a worldwide glut of chip-making capacity. It was alleged that the firms were trying to unload their excess production in the United States.

Antidumping policies are designed to punish foreign firms that engage in dumping. The ultimate objective is to protect domestic producers from unfair foreign competition. Although antidumping policies vary somewhat from country to country, the majority are similar to those used in the United States. If a domestic producer believes that a foreign firm is dumping production in the U.S. market, it can file a petition with two government agencies, the Commerce Department and the International Trade Commission. In the Korean DRAM case, Micron Technology, a U.S. manufacturer of DRAMs, filed the petition. The government agencies then investigate the complaint. If a complaint has merit, the Commerce Department may impose an antidumping duty on the offending foreign imports (antidumping duties are often called **countervailing duties**). These duties, which represent a special tariff, can be fairly substantial and stay in place for up to five years. For example, after reviewing Micron's complaint, the Commerce Department imposed 9 percent and 4 percent countervailing duties on LG Semicon and Hyundai DRAM chips, respectively. The accompanying Management Focus discusses another example of how a firm, U.S. Magnesium, used antidumping legislation to gain protection from unfair foreign competitors.

The Case for Government Intervention LO2

Now that we have reviewed the various instruments of trade policy that governments can use, it is time to look at the case for government intervention in international trade. Arguments for government intervention take two paths: political and economic. Political arguments for intervention are concerned with protecting the interests of certain groups within a nation (normally producers), often at the expense of other groups (normally consumers), or with achieving some political objective that lies outside the sphere of economic relationships, such as protecting the environment or human rights. Economic arguments for intervention are typically concerned with boosting the overall wealth of a nation (to the benefit of all, both producers and consumers).

POLITICAL ARGUMENTS FOR INTERVENTION

Political arguments for government intervention cover a range of issues, including preserving jobs, protecting industries deemed important for national security, retaliating against unfair foreign competition, protecting consumers from "dangerous" products, furthering the goals of foreign policy, and advancing the human rights of individuals in exporting countries.

Protecting Jobs and Industries

Perhaps the most common political argument for government intervention is that it is necessary for protecting jobs and industries from unfair foreign competition. The tariffs placed on imports of foreign steel by President George W. Bush in 2002 were designed to do this (many steel producers were located in states that Bush needed to win reelection in 2004), as were the tariffs placed by President Obama on Chinese tire imports (see the opening case). A political motive also underlay establishment of the Common Agricultural Policy

(CAP) by the European Union. The CAP was designed to protect the jobs of Europe's politically powerful farmers by restricting imports and guaranteeing prices. However, the higher prices that resulted from the CAP have cost Europe's consumers dearly. This is true of many attempts to protect jobs and industries through government intervention. For example, the imposition of steel tariffs in 2002 raised steel prices for American consumers, such as automobile companies, making them less competitive in the global marketplace.

National Security

Countries sometimes argue that it is necessary to protect certain industries because they are important for national security. Defense-related industries often get this kind of attention (e.g., aerospace, advanced electronics, semiconductors, etc.). Although not as common as it used to be, this argument is still made. Those in favor of protecting the U.S. semiconductor industry from foreign competition, for example, argue that semiconductors are now such important components of defense products that it would be dangerous to rely primarily on foreign producers for them. In 1986, this argument helped persuade the federal government to support Sematech, a consortium of 14 U.S. semiconductor companies that accounted for 90 percent of the U.S. industry's revenues. Sematech's mission was to conduct joint research into manufacturing techniques that can be parceled out to members. The government saw the venture as so critical that Sematech was specially protected from antitrust laws. Initially, the U.S. government provided Sematech with $100 million per year in subsidies. By the mid-1990s, however, the U.S. semiconductor industry had regained its leading market position, largely through the personal computer boom and demand for microprocessor chips made by Intel. In 1994, the consortium's board voted to seek an end to federal funding, and since 1996 the consortium has been funded entirely by private money.[14]

Retaliation

Some argue that governments should use the threat to intervene in trade policy as a bargaining tool to help open foreign markets and force trading partners to "play by the rules of the game." The U.S. government has used the threat of punitive trade sanctions to try to get the Chinese government to enforce its intellectual property laws. Lax enforcement of these laws had given rise to massive copyright infringements in China that had been costing U.S. companies such as Microsoft hundreds of millions of dollars per year in lost sales revenues. After the United States threatened to impose 100 percent tariffs on a range of Chinese imports, and after harsh words between officials from the two countries, the Chinese agreed to tighter enforcement of intellectual property regulations.[15]

If it works, such a politically motivated rationale for government intervention may liberalize trade and bring with it resulting economic gains. It is a risky strategy, however. A country that is being pressured may not back down and instead may respond to the imposition of punitive tariffs by raising trade barriers of its own. This is exactly what the Chinese government threatened to do when pressured by the United States, although it ultimately did back down. If a government does not back down, however, the results could be higher trade barriers all around and an economic loss to all involved.

Protecting Consumers

Many governments have long had regulations to protect consumers from unsafe products. The indirect effect of such regulations often is to limit or ban the importation of such products. For example, in 2003 several countries, including Japan and South Korea, decided to ban imports of American beef after a single case of mad cow disease was found in Washington state. The ban was motivated to protect consumers from what was seen to be an unsafe product. Together, Japan and South Korea accounted for about $2 billion of U.S. beef sales, so the ban had a significant impact on U.S. beef producers. After two years, both countries lifted the ban, although they placed stringent requirements on U.S. beef imports to reduce the risk of importing beef that might be tainted by mad cow disease (for example, Japan required that all beef must come from cattle under 21 months of age).[16]

The accompanying Country Focus describes how the European Union banned the sale and importation of hormone-treated beef. The ban was motivated by a desire to protect European consumers from the possible health consequences of eating meat from animals treated with growth hormones. The conflict over the importation of hormone-treated beef into the EU may prove to be a taste of things to come. In addition to the use of hormones to promote animal growth and meat production, biotechnology has made it possible to genetically alter many crops so that they resist common herbicides, produce proteins that are natural insecticides, grow dramatically improved yields, or withstand inclement weather conditions. A new breed of genetically modified tomatoes has an antifreeze gene inserted into its genome and can thus be grown in colder climates than hitherto possible. Another example is a genetically engineered cotton seed produced by Monsanto. The seed has been engineered to express a protein that protects against three common insect pests: the cotton bollworm, tobacco budworm, and pink bollworm. Use of this seed reduces or eliminates the need for traditional pesticide applications for these pests.

As enticing as such innovations sound, they have met with intense resistance from consumer groups, particularly in Europe. The fear is that the widespread use of genetically altered seed corn could have unanticipated and harmful effects on human health and may result in "genetic pollution." (An example of genetic pollution would be when the widespread use of crops that produce natural pesticides stimulates the evolution of "superbugs" that are resistant to those pesticides.) Such concerns have led Austria and Luxembourg to outlaw the importation, sale, or use of genetically altered organisms. Sentiment against genetically altered organisms also runs strong in several other European countries, most notably Germany and Switzerland. It seems likely, therefore, that the World Trade Organization will be drawn into the conflict between those that want to expand the global market for genetically altered organisms, such as Monsanto, and those that want to limit it, such as Austria and Luxembourg.[17]

Furthering Foreign Policy Objectives

Governments sometimes use trade policy to support their foreign policy objectives.[18] A government may grant preferential trade terms to a country with which it wants to build strong relations. Trade policy has also been used several times to pressure or punish "rogue states" that do not abide by international law or norms. Iraq labored under extensive trade sanctions after the UN coalition defeated the country in the 1991 Gulf War until the 2003 invasion of Iraq by U.S.-led forces. The theory is that such pressure might persuade the rogue state to mend its ways, or it might hasten a change of government. In the case of Iraq, the sanctions were seen as a way of forcing that country to comply with several UN resolutions. The United States has maintained long-running trade sanctions against Cuba. Their principal function is to impoverish Cuba in the hope that the resulting economic hardship will lead to the downfall of Cuba's Communist government and its replacement with a more democratically inclined (and pro-U.S.) regime. The United States also has had trade sanctions in place against Libya and Iran, both of which it accuses of supporting terrorist action against U.S. interests and building weapons of mass destruction. In late 2003, the sanctions against Libya seemed to yield some returns when that country announced it would terminate a program to build nuclear weapons, and the U.S. government responded by relaxing those sanctions.



Even though the United States holds trade sanctions with Cuba, other Western countries continue to trade with the island nation.

Other countries can undermine unilateral trade sanctions. The U.S. sanctions against Cuba, for example, have not stopped other Western countries from trading with Cuba. The U.S. sanctions have done little more than help create a vacuum into which other trading nations, such as Canada and Germany, have stepped. In an attempt to halt

this and further tighten the screws on Cuba, in 1996 the U.S. Congress passed the **Helms-Burton Act**. This act allows Americans to sue foreign firms that use property in Cuba confiscated from them after the 1959 revolution. Later in 1996, Congress passed a similar law, the **D'Amato Act**, aimed at Libya and Iran.

The passage of Helms-Burton elicited protests from America's trading partners, including the European Union, Canada, and Mexico, all of which claim the law violates their sovereignty and is illegal under World Trade Organization rules. For example, Canadian companies that have been doing business in Cuba for years see no reason they should suddenly be sued in U.S. courts when Canada does not restrict trade with Cuba. They are not violating Canadian law, and they are not U.S. companies, so why should they be subject to U.S. law? Despite such protests, the law is still on the books in the United States, although the U.S. government has not enforced this act—probably because it is unenforceable.

Protecting Human Rights

Protecting and promoting human rights in other countries is an important element of foreign policy for many democracies. Governments sometimes use trade policy to try to improve the human rights policies of trading partners. For years, the most obvious example of this was the annual debate in the United States over whether to grant most favored nation (MFN) status to China. MFN status allows countries to export goods to the United States under favorable terms. Under MFN rules, the average tariff on Chinese goods imported into the United States was 8 percent. If China's MFN status were rescinded, tariffs could have risen to about 40 percent. Trading partners who are signatories of the World Trade Organization, as most are, automatically receive MFN status. However, China did not join the WTO until 2001, so historically the decision of whether to grant MFN status to China was a real one. The decision was made more difficult by the perception that China had a poor human rights record. As indications of the country's disregard for human rights, critics of China often point to the 1989 Tiananmen Square massacre, China's continuing subjugation of Tibet (which China occupied in the 1950s), and the squashing of political dissent in China.[19] These critics argue that it was wrong for the United States to grant MFN status to China, and that instead, the United States should withhold MFN status until China showed measurable improvement in its human rights record. The critics argue that trade policy should be used as a political weapon to force China to change its internal policies toward human rights.

Others contend that limiting trade with such countries would make matters worse, not better. They argue that the best way to change the internal human rights stance of a country is to engage it through international trade. At its core, the argument is simple: Growing bilateral trade raises the income levels of both countries, and as a state becomes richer, its people begin to demand, and generally receive, better treatment with regard to their human rights. This is a variant of the argument in Chapter 3 that economic progress begets political progress (if political progress is measured by the adoption of a democratic government that respects human rights). This argument ultimately won the day in 1999 when the Clinton administration blessed China's application to join the WTO and announced that trade and human rights issues should be decoupled.

Protecting the Environment

Protecting the environment has become an important policy objective of many nations. Increasingly, environmental interest groups such as Friends of the Earth and the Sierra Club have been pressuring governments to regulate international trade in a way that protects the environment. The growing concern over climate change has added an important dimension to this debate.

One argument frequently made by environmental organizations is that there is a strong relationship between income levels and environmental pollution and degradation (i.e., industrial development leads to more pollution). Thus, to the extent that international trade leads to higher income levels, it can also be expected to lead to a decline in environmental quality. Organizations such as the Sierra Club argue that as a

consequence, strong environmental safeguards need to be part of any trade agreements, and governments should be allowed to restrict trade if doing so benefits the environment.

As noted in Chapter 1, the empirical evidence suggests the relationship between income levels and pollution is not a linear one, rather it is an inverted U-shaped relationship (see Figure 1.5).[20] To begin with, as countries start to climb the ladder of economic progress, pollution levels do increase, but past some threshold point, they start to decline. As societies get richer, citizens lobby for environmental protections, and governments tend to respond. We can see this process starting to unfold today in China. China has had an awful reputation for pollution, but in the past few years the Chinese government has been working hard to improve the air quality in its major cities (although it still has a considerable way to go). In developed nations such as the United States and the United Kingdom, the air is much cleaner that it was half a century ago. This data suggests that ultimately, international trade, and the growth that results from it, may not be damaging to the environment.

There is a very important exception to these trends, however, and that is emissions of carbon dioxide. Carbon dioxide emissions do rise with income levels. Thus, the country with the highest income per capita, the United States, also produces the greatest carbon dioxide emissions per capita. Carbon dioxide emissions are a by-product of energy use (i.e., oil, gas, or coal burning). Richer societies are more energy intensive, and to the extent that they use hydrocarbons to produce that energy, this leads to higher carbon dioxide emissions.

Carbon dioxide is the greenhouse gas at the center of concerns over global warming. These concerns can be stated simply.[21] First, the burning of fossil fuels to produce energy also releases carbon dioxide into the atmosphere (and atmospheric carbon dioxide concentrations have steadily increased since preindustrial times). Second, carbon dioxide absorbs heat radiated from the earth, warming the atmosphere. Third, as a consequence, average global temperatures will increase. Indeed, estimates suggest average global temperatures increased by 0.7 degree Centigrade during the last century, and they are forecasted to rise by between 1.1 and 6.4 degrees centigrade this century.[22] Fourth, as global temperatures increase, there will be environmental dislocation, ice caps will melt, sea levels will rise and flood low-lying costal areas, weather patterns will change, the frequency of violent storms will increase, tropical diseases (such as malaria) will move northward, species will go extinct, and so on.

Of course, the global climate varies naturally due to, for example, changes in solar radiation connected with the well-known sunspot cycle, volcanic activity (which can inject large amounts of sulfur dioxide particles into the atmosphere, temporarily cooling it), changes in the circulation of ocean currents, and long-term changes in the orbit of the earth and the tilt of its axis. Human-induced climate change is overlaid on these natural variations. Thus, a natural cooling trend might be moderated by greater atmospheric carbon dioxide concentrations, and a natural warming trend exacerbated by them.

Although there is debate over the precise relationship between carbon dioxide concentrations and the extent of future global warming, the vast majority of climate scientists have concluded that unless we take rapid action, we are faced with a rate of warming that is unprecedented during the history of our civilization and may cause major environmental dislocation.[23] Given this, they advocate restricting greenhouse gas emissions, particularly carbon dioxide. The first international agreement to limit global warming, the Kyoto Protocol, was signed in 1997, although its impact was reduced by the failure of two of the world's largest producers of carbon dioxide, the United States and China, to sign. A second international agreement was reached in Copenhagen in 2009, this time with the participation of the United States and China.

What does this have to do with international trade? So far, there has been little direct connection between the global warming debate and international trade. However, looking forward, adherence to targets regarding carbon emissions might start to factor into trade agreements. Specifically, if countries do not meet their targets for reducing carbon emissions specified in international treaties, they may find themselves the targets of

retaliatory action. The EU, for example, might respond to the failure of the United States to meet its treaty commitments by placing a carbon tariff on the import of certain goods from the United States. Ten years ago this was a remote possibility. Ten years from now it may be a significant factor in the international trade environment.

A second argument made with regard to environmental regulations is that in order to save money, corporations will move production to countries where environmental regulations are lax. Thus, for example, if tight environmental standards in the United States raise costs, a manufacturing firm might move production to a *pollution haven* such as Mexico where environmental standards are weaker. To protect against this possibility, environmental organizations argue that governments should place tariffs or other limitations on goods imported from countries where environmental regulations are lax.

Economists have studied this issue, but have found little evidence that firms do move production in response to changes in pollution regulations.[24] Their findings suggest that pollution abatement costs are a relatively small component of the cost structure of most enterprises, and that other factors, such as labor productivity, access to technological know-how, and transportation costs, are far more important in determining location decisions. It is also worth noting that migrating to a *pollution haven* would violate the ethical principles of many organizations (see Chapter 4 for details).

In sum, although environmental concerns have not figured significantly in trade treaties to date, there is a good chance they will do so in the future, particularly with regard to the emission of carbon dioxide and other greenhouse gases.

ECONOMIC ARGUMENTS FOR INTERVENTION

With the development of the new trade theory and strategic trade policy (see Chapter 6), the economic arguments for government intervention have undergone a renaissance in recent years. Until the early 1980s, most economists saw little benefit in government intervention and strongly advocated a free trade policy. This position has changed at the margins with the development of strategic trade policy, although as we will see in the next section, there are still strong economic arguments for sticking to a free trade stance.

The Infant Industry Argument

The **infant industry argument** is by far the oldest economic argument for government intervention. Alexander Hamilton proposed it in 1792. According to this argument, many developing countries have a potential comparative advantage in manufacturing, but new manufacturing industries cannot initially compete with established industries in developed countries. To allow manufacturing to get a toehold, the argument is that governments should temporarily support new industries (with tariffs, import quotas, and subsidies) until they have grown strong enough to meet international competition.

This argument has had substantial appeal for the governments of developing nations during the past 50 years, and the GATT has recognized the infant industry argument as a legitimate reason for protectionism. Nevertheless, many economists remain critical of this argument for two main reasons. First, protection of manufacturing from foreign competition does no good unless the protection helps make the industry efficient. In case after case, however, protection seems to have done little more than foster the development of inefficient industries that have little hope of ever competing in the world market. Brazil, for example, built the world's 10th-largest auto industry behind tariff barriers and quotas. Once those barriers were removed in the late 1980s, however, foreign imports soared, and the industry was forced to face up to the fact that after 30 years of protection, the Brazilian auto industry was one of the world's most inefficient.[25]

Second, the infant industry argument relies on an assumption that firms are unable to make efficient long-term investments by borrowing money from the domestic or international capital market. Consequently, governments have been required to subsidize long-term investments. Given the development of global capital markets over the past



COUNTRY FOCUS

Trade in Hormone-Treated Beef

In the 1970s, scientists discovered how to synthesize certain hormones and use them to accelerate the growth rate of livestock animals, reduce the fat content of meat, and increase milk production. Bovine somatotropin (BST), a growth hormone produced by cattle, was first synthesized by the biotechnology firm Genentech. Injections of BST could be used to supplement an animal's own hormone production and increase its growth rate. These hormones soon became popular among farmers, who found they could cut costs and help satisfy consumer demands for leaner meat. Although these hormones occurred naturally in animals, consumer groups in several countries soon raised concerns about the practice. They argued that the use of hormone supplements was unnatural and that the health consequences of consuming hormone-treated meat were unknown but might include hormonal irregularities and cancer.

The European Union responded to these concerns in 1989 by banning the importation of hormone-treated meat and the use of growth-promoting hormones in the production of livestock. The ban was controversial because a reasonable consensus existed among scientists that the hormones posed no health risk. Although the EU banned hormone-treated meat, many other countries did not, including big meat-producing countries such as Australia, Canada, New Zealand, and the United States. The use of hormones soon became widespread in these countries. According to trade officials outside the EU, the European ban constituted an unfair restraint on trade. As a result of this ban, exports of meat to the EU fell. For example, U.S. red meat exports to the EU declined from $231 million in 1988 to $98 million in 1994. The complaints of meat exporters were bolstered in 1995 when Codex Alimentarius, the international food standards body of the UN's Food and Agriculture Organization and the World Health Organization, approved the use of growth hormones. In making this decision, Codex reviewed the scientific literature and found no evidence of a link between the consumption of hormone-treated meat and human health problems, such as cancer.

Fortified by such decisions, in 1995 the United States pressed the EU to drop the import ban on hormone-treated beef. The EU refused, citing "consumer concerns about food safety." In response, both Canada and the United States independently filed formal complaints with the World Trade Organization. The United States was joined in its complaint by a number of other countries, including Australia and New Zealand. The WTO created a trade panel of three independent experts. After reviewing evidence and hearing from a range of experts and representatives of both parties, the panel in May 1997 ruled that the EU ban on hormone-treated beef was illegal because it had no scientific justification. The EU immediately indicated it would appeal the finding to the WTO court of appeals. The WTO court heard the appeal in November 1997 and in February 1998 agreed with the findings of the trade panel that the EU had not presented any scientific evidence to justify the hormone ban.

This ruling left the EU in a difficult position. Legally, the EU had to lift the ban or face punitive sanctions, but the ban had wide public support in Europe. The EU feared that lifting the ban could produce a consumer backlash. Instead the EU did nothing, so in February 1999 the United States asked the WTO for permission to impose punitive sanctions on the EU. The WTO responded by allowing the United States to impose punitive tariffs valued at $120 million on EU exports to the United States. The EU decided to accept these tariffs rather than lift the ban on hormone-treated beef, and as of 2011, the ban and punitive tariffs were still in place.[26]

20 years, this assumption no longer looks as valid as it once did. Today, if a developing country has a potential comparative advantage in a manufacturing industry, firms in that country should be able to borrow money from the capital markets to finance the required investments. Given financial support, firms based in countries with a potential comparative advantage have an incentive to endure the necessary initial losses in order to make long-run gains without requiring government protection. Many Taiwanese and South Korean firms did this in industries such as textiles, semiconductors, machine tools, steel, and shipping. Thus, given efficient global capital markets, the only industries that would require government protection would be those that are not worthwhile.

Strategic Trade Policy

Some new trade theorists have proposed the strategic trade policy argument.[27] We reviewed the basic argument in Chapter 6 when we considered the new trade theory. The new trade theory argues that in industries in which the existence of substantial economies of scale implies that the world market will profitably support only a few firms, countries may predominate in the export of certain products simply because they have firms that were able to capture first-mover advantages. The long-term dominance of Boeing in the commercial aircraft industry has been attributed to such factors.

The **strategic trade policy** argument has two components. First, it is argued that by appropriate actions, a government can help raise national income if it can somehow ensure that the firm or firms that gain first-mover advantages in an industry are domestic rather than foreign enterprises. Thus, according to the strategic trade policy argument, a government should use subsidies to support promising firms that are active in newly emerging industries. Advocates of this argument point out that the substantial R&D grants that the U.S. government gave Boeing in the 1950s and 1960s probably helped tilt the field of competition in the newly emerging market for passenger jets in Boeing's favor. (Boeing's first commercial jet airliner, the 707, was derived from a military plane.) Similar arguments have been made with regard to Japan's dominance in the production of liquid crystal display screens (used in laptop computers). Although these screens were invented in the United States, the Japanese government, in cooperation with major electronics companies, targeted this industry for research support in the late 1970s and early 1980s. The result was that Japanese firms, not U.S. firms, subsequently captured first-mover advantages in this market.

The second component of the strategic trade policy argument is that it might pay a government to intervene in an industry by helping domestic firms overcome the barriers to entry created by foreign firms that have already reaped first-mover advantages. This argument underlies government support of Airbus Industrie, Boeing's major competitor. Formed in 1966 as a consortium of four companies from Great Britain, France, Germany, and Spain, Airbus had less than 5 percent of the world commercial aircraft market when it began production in the mid-1970s. By 2010, it had increased its share to 45 percent, threatening Boeing's long-term dominance of the market. How did Airbus achieve this? According to the U.S. government, the answer is a $15 billion subsidy from the governments of Great Britain, France, Germany, and Spain.[28] Without this subsidy, Airbus would never have been able to break into the world market.

If these arguments are correct, they support a rationale for government intervention in international trade. Governments should target technologies that may be important in the future and use subsidies to support development work aimed at commercializing those technologies. Furthermore, government should provide export subsidies until the domestic firms have established first-mover advantages in the world market. Government support may also be justified if it can help domestic firms overcome the first-mover advantages enjoyed by foreign competitors and emerge as viable competitors in the world market (as in the Airbus and semiconductor examples). In this case, a combination of home-market protection and export-promoting subsidies may be needed.

LO3 The Revised Case for Free Trade

The strategic trade policy arguments of the new trade theorists suggest an economic justification for government intervention in international trade. This justification challenges the rationale for unrestricted free trade found in the work of classic trade theorists such as Adam Smith and David Ricardo. In response to this challenge to economic orthodoxy, a number of economists—including some of those responsible for the development of the new trade theory, such as Paul Krugman—point out that although strategic trade policy looks appealing in theory, in practice it may be unworkable. This response to the strategic trade policy argument constitutes the revised case for free trade.[29]

RETALIATION AND TRADE WAR

Krugman argues that a strategic trade policy aimed at establishing domestic firms in a dominant position in a global industry is a beggar-thy-neighbor policy that boosts national income at the expense of other countries. A country that attempts to use such policies will probably provoke retaliation. In many cases, the resulting trade war between two or more interventionist governments will leave all countries involved worse off than if a hands-off approach had been adopted in the first place. If the U.S. government were to respond to the Airbus subsidy by increasing its own subsidies to Boeing, for example, the result might be that the subsidies would cancel each other out. In the process, both European and U.S. taxpayers would end up supporting an expensive and pointless trade war, and both Europe and the United States would be worse off.

Krugman may be right about the danger of a strategic trade policy leading to a trade war. The problem, however, is how to respond when one's competitors are already being supported by government subsidies; that is, how should Boeing and the United States respond to the subsidization of Airbus? According to Krugman, the answer is probably not to engage in retaliatory action but to help establish rules of the game that minimize the use of trade-distorting subsidies. This is what the World Trade Organization seeks to do.

DOMESTIC POLICIES

Governments do not always act in the national interest when they intervene in the economy; politically important interest groups often influence them. The European Union's support for the Common Agricultural Policy (CAP), which arose because of the political power of French and German farmers, is an example. The CAP benefits inefficient farmers and the politicians who rely on the farm vote, but not consumers in the EU, who end up paying more for their foodstuffs. Thus, a further reason for not embracing strategic trade policy, according to Krugman, is that such a policy is almost certain to be captured by special-interest groups within the economy, which will distort it to their own ends. Krugman concludes that in the United States,

> To ask the Commerce Department to ignore special-interest politics while formulating detailed policy for many industries is not realistic: To establish a blanket policy of free trade, with exceptions granted only under extreme pressure, may not be the optimal policy according to the theory but may be the best policy that the country is likely to get.[30]

Development of the World Trading System LO4

Strong economic arguments support unrestricted free trade. While many governments have recognized the value of these arguments, they have been unwilling to unilaterally lower their trade barriers for fear that other nations might not follow suit. Consider the problem that two neighboring countries, say, Brazil and Argentina, face when deciding whether to lower trade barriers between them. In principle, the government of Brazil might favor lowering trade barriers, but it might be unwilling to do so for fear that Argentina will not do the same. Instead, the government might fear that the Argentineans will take advantage of Brazil's low barriers to enter the Brazilian market, while at the same time continuing to shut Brazilian products out of their market through high trade barriers. The Argentinean government might believe that it faces the same dilemma. The essence of the problem is a lack of trust. Both governments recognize that their respective nations will benefit from lower trade barriers between them, but neither government is willing to lower barriers for fear that the other might not follow.[31]

Such a deadlock can be resolved if both countries negotiate a set of rules to govern cross-border trade and lower trade barriers. But who is to monitor the governments to make sure they are playing by the trade rules? And who is to impose sanctions on a government that cheats? Both governments could set up an independent body to act as a

referee. This referee could monitor trade between the countries, make sure that no side cheats, and impose sanctions on a country if it does cheat in the trade game.

While it might sound unlikely that any government would compromise its national sovereignty by submitting to such an arrangement, since World War II an international trading framework has evolved that has exactly these features. For its first 50 years, this framework was known as the General Agreement on Tariffs and Trade. Since 1995, it has been known as the World Trade Organization. Here we look at the evolution and workings of the GATT and WTO.

FROM SMITH TO THE GREAT DEPRESSION

As noted in Chapter 5, the theoretical case for free trade dates to the late eighteenth century and the work of Adam Smith and David Ricardo. Free trade as a government policy was first officially embraced by Great Britain in 1846, when the British Parliament repealed the Corn Laws. The Corn Laws placed a high tariff on imports of foreign corn. The objectives of the Corn Laws tariff were to raise government revenues and to protect British corn producers. There had been annual motions in Parliament in favor of free trade since the 1820s when David Ricardo was a member. However, agricultural protection was withdrawn only as a result of a protracted debate when the effects of a harvest failure in Great Britain were compounded by the imminent threat of famine in Ireland. Faced with considerable hardship and suffering among the populace, Parliament narrowly reversed its long-held position.

During the next 80 years or so, Great Britain, as one of the world's dominant trading powers, pushed the case for trade liberalization, but the British government was a voice in the wilderness. Its major trading partners did not reciprocate the British policy of unilateral free trade. The only reason Britain kept this policy for so long was that as the world's largest exporting nation, it had far more to lose from a trade war than did any other country.

By the 1930s, the British attempt to stimulate free trade was buried under the economic rubble of the Great Depression. The Great Depression had roots in the failure of the world economy to mount a sustained economic recovery after the end of World War I in 1918. Things got worse in 1929 with the U.S. stock market collapse and the subsequent run on the U.S. banking system. Economic problems were compounded in 1930 when the U.S. Congress passed the Smoot-Hawley tariff. Aimed at avoiding rising unemployment by protecting domestic industries and diverting consumer demand away from foreign products, the **Smoot-Hawley Act** erected an enormous wall of tariff barriers. Almost every industry was rewarded with its "made-to-order" tariff. A particularly odd aspect of the Smoot-Hawley tariff-raising binge was that the United States was running a balance-of-payment surplus at the time and it was the world's largest creditor nation. The Smoot-Hawley Act had a damaging effect on employment abroad. Other countries reacted to the U.S. action by raising their own tariff barriers. U.S. exports tumbled in response, and the world slid further into the Great Depression.[32]

1947–1979: GATT, TRADE LIBERALIZATION, AND ECONOMIC GROWTH

Economic damage caused by the beggar-thy-neighbor trade policies that the Smoot-Hawley Act ushered in exerted a profound influence on the economic institutions and ideology of the post-World War II world. The United States emerged from the war both victorious and economically dominant. After the debacle of the Great Depression, opinion in the U.S. Congress had swung strongly in favor of free trade. Under U.S. leadership, the GATT was established in 1947.

The GATT was a multilateral agreement whose objective was to liberalize trade by eliminating tariffs, subsidies, import quotas, and the like. From its foundation in 1947 until it was superseded by the WTO, the GATT's membership grew from 19 to more

than 120 nations. The GATT did not attempt to liberalize trade restrictions in one fell swoop; that would have been impossible. Rather, tariff reduction was spread over eight rounds. The last, the Uruguay Round, was launched in 1986 and completed in December 1993. In these rounds, mutual tariff reductions were negotiated among all members, who then committed themselves not to raise import tariffs above negotiated rates. GATT regulations were enforced by a mutual monitoring mechanism. If a country believed that one of its trading partners was violating a GATT regulation, it could ask the Geneva-based bureaucracy that administered the GATT to investigate. If GATT investigators found the complaints to be valid, member countries could be asked to pressure the offending party to change its policies. In general, such pressure was sufficient to get an offending country to change its policies. If it were not, the offending country could be expelled from the GATT.

In its early years, the GATT was by most measures very successful. For example, the average tariff declined by nearly 92 percent in the United States between the Geneva Round of 1947 and the Tokyo Round of 1973–79. Consistent with the theoretical arguments first advanced by Ricardo and reviewed in Chapter 5, the move toward free trade under the GATT appeared to stimulate economic growth. From 1953 to 1963, world trade grew at an annual rate of 6.1 percent, and world income grew at an annual rate of 4.3 percent. Performance from 1963 to 1973 was even better; world trade grew at 8.9 percent annually, and world income grew at 5.1 percent annually.[33]

1980–1993: PROTECTIONIST TRENDS

During the 1980s and early 1990s, the world trading system erected by the GATT came under strain as pressures for greater protectionism increased around the world. Three reasons caused the rise in such pressures during the 1980s. First, the economic success of Japan during that time strained the world trading system (much as the success of China has created strains today). Japan was in ruins when the GATT was created. By the early 1980s, however, it had become the world's second-largest economy and its largest exporter. Japan's success in such industries as automobiles and semiconductors might have been enough to strain the world trading system. Things were made worse by the widespread perception in the West that despite low tariff rates and subsidies, Japanese markets were closed to imports and foreign investment by administrative trade barriers.

Second, the world trading system was strained by the persistent trade deficit in the world's largest economy, the United States. Although the deficit peaked in 1987 at more than $170 billion, by the end of 1992 the annual rate was still running about $80 billion. From a political perspective, the matter was worsened in 1992 by the $45 billion U.S. trade deficit with Japan, a country perceived as not playing by the rules. The consequences of the U.S. deficit included painful adjustments in industries such as automobiles, machine tools, semiconductors, steel, and textiles, where domestic producers steadily lost market share to foreign competitors. The resulting unemployment gave rise to renewed demands in the U.S. Congress for protection against imports.

A third reason for the trend toward greater protectionism was that many countries found ways to get around GATT regulations. Bilateral voluntary export restraints, or VERs, circumvent GATT agreements, because neither the importing country nor the exporting country complains to the GATT bureaucracy in Geneva—and without a complaint, the GATT bureaucracy can do nothing. Exporting countries agreed to VERs to avoid more damaging punitive tariffs. One of the best-known examples is the automobile VER between Japan and the United States, under which Japanese producers promised to limit their auto imports into the United States as a way of defusing growing trade tensions. According to a World Bank study, 13 percent of the imports of industrialized countries in 1981 were subjected to nontariff trade barriers such as VERs. By 1986, this figure had increased to 16 percent. The most rapid rise was in the United States, where the value of imports affected by nontariff barriers (primarily VERs) increased by 23 percent between 1981 and 1986.[34]

THE URUGUAY ROUND AND THE WORLD TRADE ORGANIZATION

Against the background of rising pressures for protectionism, in 1986 GATT members embarked on their eighth round of negotiations to reduce tariffs, the Uruguay Round (so named because it occurred in Uruguay). This was the most difficult round of negotiations yet, primarily because it was also the most ambitious. Until then, GATT rules had applied only to trade in manufactured goods and commodities. In the Uruguay Round, member countries sought to extend GATT rules to cover trade in services. They also sought to write rules governing the protection of intellectual property, to reduce agricultural subsidies, and to strengthen the GATT's monitoring and enforcement mechanisms.

The Uruguay Round dragged on for seven years before an agreement was reached December 15, 1993. It went into effect July 1, 1995. The Uruguay Round contained the following provisions:

1. Tariffs on industrial goods were to be reduced by more than one-third, and tariffs were to be scrapped on more than 40 percent of manufactured goods.
2. Average tariff rates imposed by developed nations on manufactured goods were to be reduced to less than 4 percent of value, the lowest level in modern history.
3. Agricultural subsidies were to be substantially reduced.
4. GATT fair trade and market access rules were to be extended to cover a wide range of services.
5. GATT rules also were to be extended to provide enhanced protection for patents, copyrights, and trademarks (intellectual property).
6. Barriers on trade in textiles were to be significantly reduced over 10 years.
7. The World Trade Organization was to be created to implement the GATT agreement.

Services and Intellectual Property

In the long run, the extension of GATT rules to cover services and intellectual property may be particularly significant. Until 1995, GATT rules applied only to industrial goods (i.e., manufactured goods and commodities). In 2007, world trade in services amounted to $3.260 billion (compared to world trade in goods of $13,570 billion).[35] Ultimately, extension of GATT rules to this important trading arena could significantly increase both the total share of world trade accounted for by services and the overall volume of world trade. The extension of GATT rules to cover intellectual property will make it much easier for high-technology companies to do business in developing nations where intellectual property rules historically have been poorly enforced (see Chapter 2 for details).

The World Trade Organization

The clarification and strengthening of GATT rules and the creation of the World Trade Organization also hold out the promise of more effective policing and enforcement of GATT rules. The WTO acts as an umbrella organization that encompasses the GATT along with two new sister bodies, one on services and the other on intellectual property. The WTO's General Agreement on Trade in Services (GATS) has taken the lead to extending free trade agreements to services. The WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) is an attempt to narrow the gaps in the way intellectual property rights are protected around the world and to bring them under common international rules. WTO has taken over responsibility for arbitrating trade disputes and monitoring the trade policies of member countries. While the WTO operates on the basis of consensus as the GATT did, in the area of dispute settlement, member countries are no longer able to block adoption of arbitration reports. Arbitration panel reports on trade disputes between member countries are automatically adopted by the WTO unless there is a consensus to reject them. Countries that have been found by

the arbitration panel to violate GATT rules may appeal to a permanent appellate body, but its verdict is binding. If offenders fail to comply with the recommendations of the arbitration panel, trading partners have the right to compensation or, in the last resort, to impose (commensurate) trade sanctions. Every stage of the procedure is subject to strict time limits. Thus, the WTO has something that the GATT never had—teeth.[36]

WTO: EXPERIENCE TO DATE

By 2011, the WTO had 153 members, including China, which joined at the end of 2001, and those countries collectively account for 97 percent of world trade. Another 25 countries, including the Russian Federation, were negotiating for membership into the organization. Since its formation, the WTO has remained at the forefront of efforts to promote global free trade. Its creators expressed the hope that the enforcement mechanisms granted to the WTO would make it more effective at policing global trade rules than the GATT had been. The great hope was that the WTO might emerge as an effective advocate and facilitator of future trade deals, particularly in areas such as services. The experience so far has been encouraging, although the collapse of WTO talks in Seattle in late 1999, slow progress with the next round of trade talks (the Doha Round), and a shift back toward some limited protectionism following the global financial crisis of 2008–2009 have raised a number of questions about the future direction of the WTO.

WTO as Global Police

The first 15 years in the life of the WTO suggests that its policing and enforcement mechanisms are having a positive effect.[37] Between 1995 and 2010 more than 400 trade disputes between member countries were brought to the WTO.[38] This record compares with a total of 196 cases handled by the GATT over almost half a century. Of the cases brought to the WTO, three-fourths had been resolved by informal consultations between the disputing countries. Resolving the remainder has involved more formal procedures, but these have been largely successful. In general, countries involved have adopted the WTO's recommendations. The fact that countries are using the WTO represents an important vote of confidence in the organization's dispute resolution procedures.

Expanding Trade Agreements

As explained above, the Uruguay Round of GATT negotiations extended global trading rules to cover trade in services. The WTO was given the role of brokering future agreements to open up global trade in services. The WTO was also encouraged to extend its reach to encompass regulations governing foreign direct investment, something the GATT had never done. Two of the first industries targeted for reform were the global telecommunication and financial services industries.

In February 1997, the WTO brokered a deal to get countries to agree to open their telecommunication markets to competition, allowing foreign operators to purchase ownership stakes in domestic telecommunication providers and establishing a set of common rules for fair competition. Under the pact, 68 countries accounting for more than 90 percent of world telecommunication revenues pledged to start opening their markets to foreign competition and to abide by common rules for fair competition in telecommunications. Most of the world's biggest markets, including the United States, European Union, and Japan, were fully liberalized by January 1, 1998, when the pact went into effect. All forms of basic telecommunication service are covered, including voice telephony, data and fax transmissions, and satellite and radio communications. Many telecommunication companies responded positively to the deal, pointing out that it would give them a much greater ability to offer their business customers one-stop shopping—a global, seamless service for all their corporate needs and a single bill.[39]

This was followed in December 1997 with an agreement to liberalize cross-border trade in financial services.[40] The deal covers more than 95 percent of the world's financial services market. Under the agreement, which took effect at the beginning of March

1999, 102 countries pledged to open to varying degrees their banking, securities, and insurance sectors to foreign competition. In common with the telecommunication deal, the accord covers not just cross-border trade but also foreign direct investment. Seventy countries agreed to dramatically lower or eradicate barriers to foreign direct investment in their financial services sector. The United States and the European Union, with minor exceptions, are fully open to inward investment by foreign banks, insurance, and securities companies. As part of the deal, many Asian countries made important concessions that allow significant foreign participation in their financial services sectors for the first time.

The WTO in Seattle: A Watershed?

At the end of November 1999, representatives from the WTO's member states met in Seattle, Washington. The goal of the meeting was to launch a new round of talks—dubbed "the millennium round"—aimed at further reducing barriers to cross-border trade and investment. Prominent on the agenda was an attempt to get the assembled countries to agree to work toward the reduction of barriers to cross-border trade in agricultural products and trade and investment in services.

These expectations were dashed on the rocks of a hard and unexpected reality. The talks ended December 3, 1999, without any agreement being reached. Inside the meeting rooms, the problem was an inability to reach consensus on the primary goals for the next round of talks. A major stumbling block was friction between the United States and the European Union over whether to endorse the aim of ultimately eliminating subsidies to agricultural exporters. The United States wanted the elimination of such subsidies to be a priority. The EU, with its politically powerful farm lobby and long history of farm subsidies, was unwilling to take this step. Another stumbling block was related to efforts by the United States to write "basic labor rights" into the law of the world trading system. The United States wanted the WTO to allow governments to impose tariffs on goods imported from countries that did not abide by what the United States saw as fair labor practices. Representatives from developing nations reacted angrily to this proposal, suggesting it was simply an attempt by the United States to find a legal way of restricting imports from poorer nations.



WTO protesters gather in downtown Seattle before the opening of the WTO sessions in Seattle in 1999.

While the disputes inside the meeting rooms were acrimonious, it was events outside that captured the attention of the world press. The WTO talks proved to be a lightning rod for a diverse collection of organizations from environmentalists and human rights groups to labor unions. For various reasons, these groups oppose free trade. All these organizations argued that the WTO is an undemocratic institution that was usurping the national sovereignty of member states and making decisions of great importance behind closed doors. They took advantage of the Seattle meetings to voice their opposition, which the world press recorded.

Environmentalists expressed concern about the impact that free trade in agricultural products might have on the rate of global deforestation. They argued that lower tariffs on imports of lumber from developing nations will stimulate demand and accelerate the rate at which virgin forests are logged, particularly in nations such as Malaysia and Indonesia. They also pointed to the adverse impact that some WTO rulings have had on environmental policies. For example, the WTO had blocked a U.S. rule that ordered shrimp nets be equipped with a device that allows endangered sea turtles to escape. The WTO found the rule discriminated against foreign importers who lacked such nets.[41] Environmentalists argued that the rule was necessary to protect the turtles from extinction.

Human rights activists see WTO rules as outlawing the ability of nations to stop imports from countries where child labor is used or working conditions are hazardous. Similarly, labor unions oppose trade laws that allow imports from low-wage countries and result in a loss of jobs in high-wage countries. They buttress their position by arguing that American workers are losing their jobs to imports from developing nations that do not have adequate labor standards.

Supporters of the WTO and free trade dismiss these concerns. They have repeatedly pointed out that the WTO exists to serve the interests of its member states, not subvert them. The WTO lacks the ability to force any member nation to take an action to which it is opposed. The WTO can allow member nations to impose retaliatory tariffs on countries that do not abide by WTO rules, but that is the limit of its power. Furthermore, supporters argue, it is rich countries that pass strict environmental laws and laws governing labor standards, not poor ones. In their view, free trade, by raising living standards in developing nations, will be followed by the passage of such laws in these nations. Using trade regulations to try to impose such practices on developing nations, they believe, will produce a self-defeating backlash.

Many representatives from developing nations, which make up about 70 percent of the WTO's members, also reject the position taken by environmentalists and advocates of human and labor rights. Poor countries, which depend on exports to boost their economic growth rates and work their way out of poverty, fear that rich countries will use environmental concerns, human rights, and labor-related issues to erect barriers to the products of the developing world. They believe that attempts to incorporate language about the environment or labor standards in future trade agreements will amount to little more than trade barriers by another name.[42] If this were to occur, they argue that the effect would be to trap the developing nations of the world in a grinding cycle of poverty and debt.

As the WTO representatives gathered in Seattle, environmentalists, human rights activists, and labor unions marched in the streets. Some of the more radical elements in these organizations, together with groups of anarchists who were philosophically opposed to "global capitalism" and "the rape of the world by multinationals," succeeded not only in shutting down the opening ceremonies of the WTO but also in sparking violence in the normally peaceful streets of Seattle. A number of demonstrators damaged property and looted, and the police responded with tear gas, rubber bullets, pepper spray, and baton charges. When it was over, 600 demonstrators had been arrested, millions of dollars in property had been damaged in downtown Seattle, and the global news media had their headline: "WTO Talks Collapse amid Violent Demonstrations."

What happened in Seattle is notable because it may have been a watershed of sorts. In the past, previous trade talks were pursued in relative obscurity with only interested economists, politicians, and businesspeople paying much attention. Seattle demonstrated

that the issues surrounding the global trend toward free trade have moved to center stage in the popular consciousness, and they have remained there ever since. The debate on the merits of free trade and globalization has become mainstream. Whether further liberalization occurs, therefore, may depend on the importance that popular opinion in countries such as the United States attaches to issues such as human rights and labor standards, job security, environmental policies, and national sovereignty. It will also depend on the ability of advocates of free trade to articulate in a clear and compelling manner the argument that, in the long run, free trade is the best way of promoting adequate labor standards, of providing more jobs, and of protecting the environment.

THE FUTURE OF THE WTO: UNRESOLVED ISSUES AND THE DOHA ROUND

Much remains to be done on the international trade front. Four issues at the forefront of the current agenda of the WTO are the increase in antidumping policies, the high level of protectionism in agriculture, the lack of strong protection for intellectual property rights in many nations, and continued high tariff rates on nonagricultural goods and services in many nations. We shall look at each in turn before discussing the latest round of talks between WTO members aimed at reducing trade barriers, the Doha Round, which began in 2001 and was still ongoing as of 2011.

Antidumping Actions

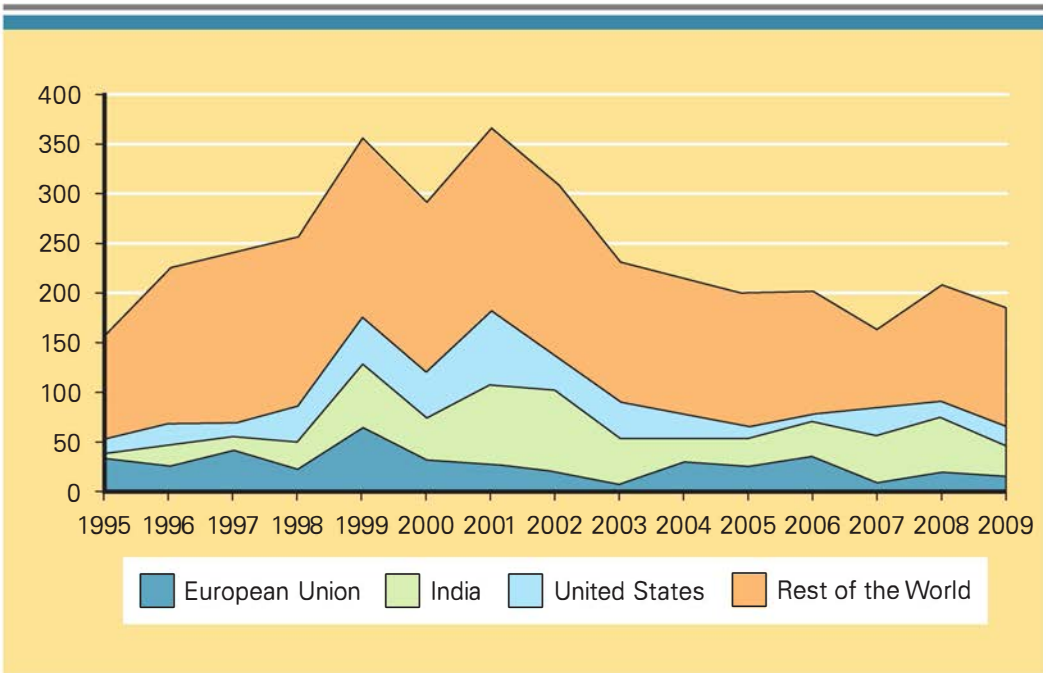
Antidumping actions proliferated during the 1990s. WTO rules allow countries to impose antidumping duties on foreign goods that are being sold cheaper than at home, or below their cost of production, when domestic producers can show that they are being harmed. Unfortunately, the rather vague definition of what constitutes "dumping" has proved to be a loophole that many countries are exploiting to pursue protectionism.

Between 1995 and mid-2010, WTO members had reported implementation of some 3,752 antidumping actions to the WTO. India initiated the largest number of antidumping actions, some 613; the EU initiated 414 over the same period, and the United States 442 (see Figure 7.2). Antidumping actions seem to be concentrated in certain sectors of the economy such as basic metal industries (e.g., aluminum and steel), chemicals, plastics, and machinery and electrical equipment.[43] These sectors account for some

FIGURE 7.2

Antidumping Actions

Source: Constructed by author from WTO data.



70 percent of all antidumping actions reported to the WTO. These four sectors since 1995 have been characterized by periods of intense competition and excess productive capacity, which have led to low prices and profits (or losses) for firms in those industries. It is not unreasonable, therefore, to hypothesize that the high level of antidumping actions in these industries represents an attempt by beleaguered manufacturers to use the political process in their nations to seek protection from foreign competitors, who they claim are engaging in unfair competition. While some of these claims may have merit, the process can become very politicized as representatives of businesses and their employees lobby government officials to "protect domestic jobs from unfair foreign competition," and government officials, mindful of the need to get votes in future elections, oblige by pushing for antidumping actions. The WTO is clearly worried by this trend, suggesting that it reflects persistent protectionist tendencies and pushing members to strengthen the regulations governing the imposition of antidumping duties.

Figure 7.2 suggests that antidumping actions peaked in the 1999–2001 time period and declined thereafter until the WTO reported a small rise in antidumping actions in 2008 as the global financial crisis took hold. Many of these actions seem to have been a direct response to the decline in global demand that followed the financial crisis, and the increase suggests that countries were using antidumping actions as a means of protecting domestic producers. The most frequent target of these actions was China.

Protectionism in Agriculture

Another recent focus of the WTO has been the high level of tariffs and subsidies in the agricultural sector of many economies. Tariff rates on agricultural products are generally much higher than tariff rates on manufactured products or services. For example, in the mid-2000s the average tariff rates on nonagricultural products were 4.2 percent for Canada, 3.8 percent for the European Union, 3.9 percent for Japan, and 4.4 percent for the United States. On agricultural products, however, the average tariff rates were 21.2 percent for Canada, 15.9 percent for the European Union, 18.6 percent for Japan, and 10.3 percent for the United States.[44] The implication is that consumers in these countries are paying significantly higher prices than necessary for agricultural products imported from abroad, which leaves them with less money to spend on other goods and services.

The historically high tariff rates on agricultural products reflect a desire to protect domestic agriculture and traditional farming communities from foreign competition. In addition to high tariffs, agricultural producers also benefit from substantial subsidies. According to estimates from the Organization for Economic Cooperation and Development (OECD), government subsidies on average account for some 17 percent of the cost of agricultural production in Canada, 21 percent in the United States, 35 percent in the European Union, and 59 percent in Japan.[45] In total, OECD countries spend more than $300 billion a year in subsidies to agricultural producers.

Not surprisingly, the combination of high tariff barriers and significant subsidies introduces significant distortions into the production of agricultural products and international trade of those products. The net effect is to raise prices to consumers, reduce the volume of agricultural trade, and encourage the overproduction of products that are heavily subsidized (with the government typically buying the surplus). Because global trade in agriculture currently amounts to 10.5 percent of total merchandized trade, or about $750 billion per year, the WTO argues that removing tariff barriers and subsidies could significantly boost the overall level of trade, lower prices to consumers, and raise global economic growth by freeing consumption and investment resources for more productive uses. According to estimates from the International Monetary Fund, removal of tariffs and subsidies on agricultural products would raise global economic welfare by $128 billion annually.[46] Others suggest gains as high as $182 billion.[47]

The biggest defenders of the existing system have been the advanced nations of the world, which want to protect their agricultural sectors from competition by low-cost producers in developing nations. In contrast, developing nations have been pushing hard for reforms that would allow their producers greater access to the protected markets

of the developed nations. Estimates suggest that removing all subsidies on agricultural production alone in OECD countries could return to the developing nations of the world three times more than all the foreign aid they currently receive from the OECD nations.[48] In other words, free trade in agriculture could help to jump-start economic growth among the world's poorer nations and alleviate global poverty.

Protecting Intellectual Property

Another issue that has become increasingly important to the WTO has been protecting intellectual property. The 1995 Uruguay agreement that established the WTO also contained an agreement to protect intellectual property (the Trade-Related Aspects of Intellectual Property Rights, or TRIPS, agreement). The TRIPS regulations oblige WTO members to grant and enforce patents lasting at least 20 years and copyrights lasting 50 years. Rich countries had to comply with the rules within a year. Poor countries, in which such protection generally was much weaker, had five years' grace, and the very poorest had 10 years. The basis for this agreement was a strong belief among signatory nations that the protection of intellectual property through patents, trademarks, and copyrights must be an essential element of the international trading system. Inadequate protections for intellectual property reduce the incentive for innovation. Because innovation is a central engine of economic growth and rising living standards, the argument has been that a multilateral agreement is needed to protect intellectual property.

Without such an agreement it is feared that producers in a country, let's say India, might market imitations of patented innovations pioneered in a different country, say the United States. This can affect international trade in two ways. First, it reduces the export opportunities in India for the original innovator in the United States. Second, to the extent that the Indian producer is able to export its pirated imitation to additional countries, it also reduces the export opportunities in those countries for the U.S. inventor. Also, one can argue that because the size of the total world market for the innovator is reduced, its incentive to pursue risky and expensive innovations is also reduced. The net effect would be less innovation in the world economy and less economic growth.

Something very similar to this occurred in the pharmaceutical industry, with Indian drug companies making copies of patented drugs discovered elsewhere. In 1970, the Indian government stopped recognizing product patents on drugs, but it elected to continue respecting process patents. This permitted Indian companies to reverse-engineer Western pharmaceuticals without paying licensing fees. As a result, foreigners' share of the Indian drug market fell from 75 percent in 1970 to 30 percent in 2000. For example, an Indian company sold a version of Bayer's patented antibiotic Cipro for $0.12 a pill, versus the $5.50 it costs in the United States. Under the WTO TRIPS agreement, India agreed to adopt and enforce the international drug patent regime in 2005.[49]

As noted in Chapter 2, intellectual property rights violation is also an endemic problem in several other industries, most notably computer software and music. The WTO believes that reducing piracy rates in areas such as drugs, software, and music recordings would have a significant impact on the volume of world trade and increase the incentive for producers to invest in the creation of intellectual property. A world without piracy would have more new drugs, computer software, and music recordings produced every year. In turn, this would boost economic and social welfare, and global economic growth rates. It is thus in the interests of WTO members to make sure that intellectual property rights are respected and enforced. While the 1995 Uruguay agreement that created the WTO did make headway with the TRIPS agreement, some believe these requirements do not go far enough and further commitments are necessary.

Market Access for Nonagricultural Goods and Services

Although the WTO and the GATT have made big strides in reducing the tariff rates on nonagricultural products, much work remains. Although most developed nations have brought their tariff rates on industrial products down to an *average* of 3.8 percent of value, exceptions still remain. In particular, while average tariffs are low, high tariff rates

TABLE 7.1

Bound Tariffs on Select Industrial Products (Simple Averages)

Source: WTO.

Country	Metals	Transportation Equipment	Electric Machinery
Canada	2.8%	6.8%	5.2%
United States	1.8	2.7	2.1
Brazil	33.4	33.6	31.9
Mexico	34.7	35.8	34.1
European Union	1.6	4.7	3.3
Australia	4.5	15.1	13.3
Japan	0.9	0.0	0.2
South Korea	7.7	24.6	16.1

persist on certain imports into developed nations, which limit market access and economic growth. For example, Australia and South Korea, both OECD countries, still have bound tariff rates of 15.1 percent and 24.6 percent, respectively, on imports of transportation equipment (*bound tariff rates* are the highest rate that can be charged, which is often, but not always, the rate that is charged). In contrast, the bound tariff rates on imports of transportation equipment into the United States, EU, and Japan are 2.7 percent, 4.8 percent, and 0 percent, respectively (see Table 7.1). A particular area for concern is high tariff rates on imports of selected goods from developing nations into developed nations.

In addition, tariffs on services remain higher than on industrial goods. The average tariff on business and financial services imported into the United States, for example, is 8.2 percent, into the EU it is 8.5 percent, and into Japan it is 19.7 percent.[50] Given the rising value of cross-border trade in services, reducing these figures can be expected to yield substantial gains.

The WTO would like to bring down tariff rates still further and reduce the scope for the selective use of high tariff rates. The ultimate aim is to reduce tariff rates to zero. Although this might sound ambitious, 40 nations have already moved to zero tariffs on information technology goods, so a precedent exists. Empirical work suggests that further reductions in average tariff rates toward zero would yield substantial gains. One estimate by economists at the World Bank suggests that a broad global trade agreement coming out of the current Doha negotiations could increase world income by $263 billion annually, of which $109 billion would go to poor countries.[51] Another estimate from the OECD suggest a figure closer to $300 billion annually.[52] See the accompanying Country Focus for estimates of the benefits to the American economy from free trade.

Looking further out, the WTO would like to bring down tariff rates on imports of nonagricultural goods into developing nations. Many of these nations use the infant industry argument to justify the continued imposition of high tariff rates; however, ultimately these rates need to come down for these nations to reap the full benefits of international trade. For example, the bound tariff rates of 53.9 percent on imports of transportation equipment into India and 33.6 percent on imports into Brazil, by raising domestic prices, help to protect inefficient domestic producers and limit economic growth by reducing the real income of consumers who must pay more for transportation equipment and related services.

A New Round of Talks: Doha

Antidumping actions, trade in agricultural products, better enforcement of intellectual property laws, and expanded market access were four of the issues the WTO wanted to tackle at the 1999 meetings in Seattle, but those meetings were derailed. In late 2001, the WTO tried again to launch a new round of talks between member states aimed at

COUNTRY FOCUS

Estimating the Gains from Trade for America

A study published by the Institute for International Economics tried to estimate the gains to the American economy from free trade. According to the study, due to reductions in tariff barriers under the GATT and WTO since 1947, by 2003 the gross domestic product (GDP) of the United States was 7.3 percent higher than would otherwise be the case. The benefits of that amounted to roughly $1 trillion a year, or $9,000 extra income for each American household per year.

The same study tried to estimate what would happen if America concluded free trade deals with all its trading partners, reducing tariff barriers on all goods and services to zero. Using several methods to estimate the impact, the study concluded that additional annual gains of between $450 billion and $1.3 trillion could be realized. This final march to free trade, according to the authors of the study, could safely be expected to raise incomes of the average American household by an additional $4,500 per year.

The authors also tried to estimate the scale and cost of employment disruption that would be caused by a move to universal free trade. Jobs would be lost in certain sectors and gained in others if the country abolished all tariff barriers. Using historical data as a guide, they estimated that 226,000 jobs would be lost every year due to expanded trade, although some two-thirds of those losing jobs would find reemployment after a year. Reemployment, however, would be at a wage that was 13 to 14 percent lower. The study concluded that the disruption costs would total some $54 billion annually, primarily in the form of lower lifetime wages to those whose jobs were disrupted as a result of free trade. Offset against this, however, must be the higher economic growth resulting from free trade, which creates many new jobs and raises household incomes, creating another $450 billion to $1.3 trillion annually in *net* gains to the economy. In other words, the estimated annual gains from trade are far greater than the estimated annual costs associated with job disruption, and more people benefit than lose as result of shift to a universal free trade regime.[53]

further liberalizing the global trade and investment framework. For this meeting, it picked the remote location of Doha in the Persian Gulf state of Qatar, no doubt with an eye on the difficulties that antiglobalization protesters would have in getting there. Unlike the Seattle meetings, at Doha, the member states of the WTO agreed to launch a new round of talks and staked out an agenda. The talks were originally scheduled to last three years, although they have already gone on longer and may not be concluded for a while.

The agenda includes cutting tariffs on industrial goods and services, phasing out subsidies to agricultural producers, reducing barriers to cross-border investment, and limiting the use of antidumping laws. Some difficult compromises were made to reach agreement on this agenda. The EU and Japan had to give significant ground on the issue of agricultural subsidies, which are used extensively by both entities to support politically powerful farmers. The United States bowed to pressure from virtually every other nation to negotiate revisions of antidumping rules, which the United States has used extensively to protect its steel producers from foreign competition. Europe had to scale back its efforts to include environmental policy in the trade talks, primarily because of pressure from developing nations that see environmental protection policies as trade barriers by another name. Excluded from the agenda was any language pertaining to attempts to tie trade to labor standards in a country.

Countries with big pharmaceutical sectors acquiesced to demands from African, Asian, and Latin American nations on the issue of drug patents. Specifically, the language in the agreement declares that WTO regulation on intellectual property "does not and should not prevent members from taking measures to protect public health." This language was meant to assure the world's poorer nations that they can make or buy generic equivalents to fight such killers as AIDS and malaria.

Clearly, it is one thing to agree to an agenda and quite another to reach a consensus on a new treaty. Nevertheless, if an agreement is reached there are some clear potential winners. These include low-cost agricultural producers in the developing world and developed nations such as Australia and the United States. If the talks are successful, agricultural producers in these nations will ultimately see the global markets for their goods expand. Developing nations also gain from the lack of language on labor standards, which many saw as an attempt by rich nations to erect trade barriers. The sick and poor of the world also benefit from guaranteed access to cheaper medicines. There are also clear losers in this agreement, including EU and Japanese farmers, U.S. steelmakers, environmental activists, and pharmaceutical firms in the developed world. These losers can be expected to lobby their governments hard during the ensuing years to make sure the final agreement is more in their favor.[54] In general, though, if ultimately successful, the Doha Round of negotiations could significantly raise global economic welfare. As noted above, estimates suggest that a successful Doha Round would raise global incomes by as much as $300 billion annually, with 60 percent of the gain going to the world's poorer nations, which would help to pull 150 million people out of poverty.[55]

The talks are currently ongoing, and as seems normal in these cases, they are characterized by halting progress punctuated by significant setbacks and missed deadlines. A September 2003 meeting in Cancun, Mexico, broke down, primarily because there was no agreement on how to proceed with reducing agricultural subsidies and tariffs; the EU, United States, and India, among others, proved less than willing to reduce tariffs and subsidies to their politically important farmers, while countries such as Brazil and certain West African nations wanted free trade as quickly as possible. In 2004, both the United States and the EU made a determined push to start the talks again. However, since then little progress has been made and the talks are in deadlock, primarily because of disagreements over how deep the cuts in subsidies to agricultural produces should be. As of early 2011, the goal was to reduce tariffs for manufactured and agricultural goods by 60 to 70 percent, and to cut subsidies to half of their current level, but getting nations to agree to these goals was proving exceedingly difficult.

IMPLICATION FOR MANAGERS



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What are the implications of all this for business practice? Why should the international manager care about the political economy of free trade or about the relative merits of arguments for free trade and protectionism? There are two answers to this question. The first concerns the impact of trade barriers on a firm's strategy. The second concerns the role that business firms can play in promoting free trade or trade barriers.

TRADE BARRIERS AND FIRM STRATEGY

To understand how trade barriers affect a firm's strategy, consider first the material in Chapter 6. Drawing on the theories of international trade, we discussed how it makes sense for the firm to disperse its various production activities to those countries around the globe where they can be performed most efficiently. Thus, it may make sense for a firm to design and engineer its product in one country, to manufacture components in another, to perform final assembly operations in yet another country, and then export the finished product to the rest of the world.

Clearly, trade barriers constrain a firm's ability to disperse its productive activities in such a manner. First and most obvious, tariff barriers raise the costs of exporting products to a country (or of exporting partly finished products between countries). This may put the firm at a competitive disadvantage to indigenous competitors in that country. In response, the firm may then find it economical to locate production facilities

in that country so that it can compete on an even footing. Second, quotas may limit a firm's ability to serve a country from locations outside of that country. Again, the response by the firm might be to set up production facilities in that country—even though it may result in higher production costs. Such reasoning was one of the factors behind the rapid expansion of Japanese automaking capacity in the United States during the 1980s and 1990s. This followed the establishment of a VER agreement between the United States and Japan that limited U.S. imports of Japanese automobiles.

Third, to conform to local content regulations, a firm may have to locate more production activities in a given market than it would otherwise. Again, from the firm's perspective, the consequence might be to raise costs above the level that could be achieved if each production activity was dispersed to the optimal location for that activity. And finally, even when trade barriers do not exist, the firm may still want to locate some production activities in a given country to reduce the threat of trade barriers being imposed in the future.

All these effects are likely to raise the firm's costs above the level that could be achieved in a world without trade barriers. The higher costs that result need not translate into a significant competitive disadvantage relative to other foreign firms, however, if the countries imposing trade barriers do so to the imported products of all foreign firms, irrespective of their national origin. But when trade barriers are targeted at exports from a particular nation, firms based in that nation are at a competitive disadvantage to firms of other nations. The firm may deal with such targeted trade barriers by moving production into the country imposing barriers. Another strategy may be to move production to countries whose exports are not targeted by the specific trade barrier.

Finally, the threat of antidumping action limits the ability of a firm to use aggressive pricing to gain market share in a country. Firms in a country also can make strategic use of antidumping measures to limit aggressive competition from low-cost foreign producers. For example, the U.S. steel industry has been very aggressive in bringing antidumping actions against foreign steelmakers, particularly in times of weak global demand for steel and excess capacity. In 1998 and 1999, the United States faced a surge in low-cost steel imports as a severe recession in Asia left producers there with excess capacity. The U.S. producers filed several complaints with the International Trade Commission. One argued that Japanese producers of hot rolled steel were selling it at below cost in the United States. The ITC agreed and levied tariffs ranging from 18 percent to 67 percent on imports of certain steel products from Japan (these tariffs are separate from the steel tariffs discussed earlier).[56]

POLICY IMPLICATIONS

As noted in Chapter 6, business firms are major players on the international trade scene. Because of their pivotal role in international trade, firms can and do exert a strong influence on government policy toward trade. This influence can encourage protectionism or it can encourage the government to support the WTO and push for open markets and freer trade among all nations. Government policies with regard to international trade can have a direct impact on business.

Consistent with strategic trade policy, examples can be found of government intervention in the form of tariffs, quotas, antidumping actions, and subsidies helping firms and industries establish a competitive advantage in the world economy. In general, however, the arguments contained in this chapter and in Chapter 6 suggest that government intervention has three drawbacks. Intervention can be self-defeating because it tends to protect the inefficient rather than help firms become efficient global competitors. Intervention is dangerous; it may invite retaliation and trigger a trade war. Finally, intervention is unlikely to be well executed, given the opportunity for such a policy to be captured by special-interest groups. Does this mean that business should simply encourage government to adopt a laissez-faire free trade policy?

Most economists would probably argue that the best interests of international business are served by a free trade stance, but not a laissez-faire stance. It is probably in the best long-run interests of the business community to encourage the government to aggressively

promote greater free trade by, for example, strengthening the WTO. Business probably has much more to gain from government efforts to open protected markets to imports and foreign direct investment than from government efforts to support certain domestic industries in a manner consistent with the recommendations of strategic trade policy.

This conclusion is reinforced by a phenomenon we touched on in Chapter 1—the increasing integration of the world economy and internationalization of production that has occurred over the past two decades. We live in a world where many firms of all national origins increasingly depend for their competitive advantage on globally dispersed production systems. Such systems are the result of freer trade. Freer trade has brought great advantages to firms that have exploited it and to consumers who benefit from the resulting lower prices. Given the danger of retaliatory action, business firms that lobby their governments to engage in protectionism must realize that by doing so they may be denying themselves the opportunity to build a competitive advantage by constructing a globally dispersed production system. By encouraging their governments to engage in protectionism, their own activities and sales overseas may be jeopardized if other governments retaliate. This does not mean a firm should never seek protection in the form of antidumping actions and the like, but it should review its options carefully and think through the larger consequences.

CHAPTER SUMMARY

This chapter described how the reality of international trade deviates from the theoretical ideal of unrestricted free trade reviewed in Chapter 6. In this chapter, we reported the various instruments of trade policy, reviewed the political and economic arguments for government intervention in international trade, reexamined the economic case for free trade in light of the strategic trade policy argument, and looked at the evolution of the world trading framework. While a policy of free trade may not always be the theoretically optimal policy (given the arguments of the new trade theorists), in practice it is probably the best policy for a government to pursue. In particular, the long-run interests of business and consumers may be best served by strengthening international institutions such as the WTO. Given the danger that isolated protectionism might escalate into a trade war, business probably has far more to gain from government efforts to open protected markets to imports and foreign direct investment (through the WTO) than from government efforts to protect domestic industries from foreign competition. The chapter made the following points:

1. Trade policies such as tariffs, subsidies, antidumping regulations, and local content requirements tend to be pro-producer and anti-consumer. Gains accrue to producers (who are protected from foreign competitors), but consumers lose because they must pay more for imports.
2. There are two types of arguments for government intervention in international trade: political and economic. Political arguments for intervention are concerned with protecting the interests of certain groups, often at the expense of other groups, or with promoting goals with regard to foreign policy, human rights, consumer protection, and the like. Economic arguments for intervention are about boosting the overall wealth of a nation.
3. A common political argument for intervention is that it is necessary to protect jobs. However, political intervention often hurts consumers and it can be self-defeating. Countries sometimes argue that it is important to protect certain industries for reasons of national security. Some argue that government should use the threat to intervene in trade policy as a bargaining tool to open foreign markets. This can be a risky policy; if it fails, the result can be higher trade barriers.
4. The infant industry argument for government intervention contends that to let manufacturing get a toehold, governments should temporarily support new industries. In practice, however, governments often end up protecting the inefficient.
5. Strategic trade policy suggests that with subsidies, government can help domestic firms gain first-mover advantages in global industries where economies of scale are important. Government subsidies may also help domestic firms overcome barriers to entry into such industries.

6. The problems with strategic trade policy are twofold: (*a*) such a policy may invite retaliation, in which case all will lose, and (*b*) strategic trade policy may be captured by special-interest groups, which will distort it to their own ends.
7. The GATT was a product of the postwar free trade movement. The GATT was successful in lowering trade barriers on manufactured goods and commodities. The move toward greater free trade under the GATT appeared to stimulate economic growth.
8. The completion of the Uruguay Round of GATT talks and the establishment of the World Trade Organization have strengthened the world trading system by extending GATT rules to services, increasing protection for intellectual property, reducing agricultural subsidies, and enhancing monitoring and enforcement mechanisms.
9. Trade barriers act as a constraint on a firm's ability to disperse its various production activities to optimal locations around the globe. One response to trade barriers is to establish more production activities in the protected country.
10. Business may have more to gain from government efforts to open protected markets to imports and foreign direct investment than from government efforts to protect domestic industries from foreign competition.

Critical Thinking and Discussion Questions

1. Do you think governments should consider human rights when granting preferential trading rights to countries? What are the arguments for and against taking such a position?
2. Whose interests should be the paramount concern of government trade policy—the interests of producers (businesses and their employees) or those of consumers?
3. Given the arguments relating to the new trade theory and strategic trade policy, what kind of trade policy should business be pressuring government to adopt?
4. You are an employee of a U.S. firm that produces personal computers in Thailand and then exports them to the United States and other countries for sale. The personal computers were originally produced in Thailand to take advantage of relatively low labor costs and a skilled workforce. Other possible locations considered at the time were Malaysia and Hong Kong. The U.S. government decides to impose punitive 100 percent ad valorem tariffs on imports of computers from Thailand to punish the country for administrative trade barriers that restrict U.S. exports to Thailand. How should your firm respond? What does this tell you about the use of targeted trade barriers?
5. Reread the Management Focus, "U.S. Magnesium Seeks Protection." Who gains most from the antidumping duties levied by the United States on imports of magnesium from China and Russia? Who are the losers? Are these duties in the best national interests of the United States?

Research Task globalEDGE globaledge.msu.edu

The Political Economy of International Trade

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The European subsidiary of your company is considering exporting its products to Egypt. Yet, management's current knowledge of this country's trade policies and barriers is limited. Before your company's management decides to export, a more detailed analysis of the political and economic conditions in Egypt is required. In fact, you have heard that the *Market Access Database* may be a good place to start. Begin your search and identify Egypt's current import policies with respect to fundamental issues such as tariffs and restrictions. Prepare an executive summary of your findings.

Exercise 2

The number of member nations of the World Trade Organization (WTO) has increased considerably in recent years. As a *global international organization*, some nonmember countries have observer status in the WTO. Such status requires accession negotiations to begin within five years of attaining this preliminary position. Identify the current total number of WTO members. Also, prepare a list of current observer countries. Do you notice anything in particular about the countries that have observer status?

CLOSING CASE

The Global Financial Crisis and Protectionism

Two facts have characterized international trade between 1986 and 2007. First, the volume of world trade grew every year, creating an increasingly interdependent global economy, and second, barriers to international trade were progressively reduced. Between 1990 and 2007 international trade grew by 6 percent annually compounded, while import tariffs on goods fell from an average of 26 percent in 1986 to 8.8 percent in 2007. In the wake of the global financial crisis that started in the United States in 2008 and quickly spread around the world, this changed. As global demand slumped and financing for international trade dried up in the wake of tight credit conditions, so did the volume of international trade. The volume of world trade fell by 2 percent in 2008, the first decline since 1982, and then slumped a further 12 percent in 2009.

This contraction is alarming because past sharp declines in trade have been followed by calls for greater protectionism from foreign competition as governments try to protect jobs at home in the wake of declining demand. This is what occurred in the 1930s, when shrinking trade was followed quickly by increases in trade barriers, mostly in the form of higher tariffs. This actually made the situation far worse and led to the Great Depression.

Much has changed since the 1930s. Treaties now in place limit the ability of national governments to raise trade barriers. Most notably, World Trade Organization rules in theory constrain the ability of countries to implement significant increases in trade barriers. But WTO rules are not perfect and there is plenty of evidence that countries are finding ways to raise barriers to international trade. Many developing countries have latitude under WTO rules to raise some tariffs, and according to the World Bank, in 2008 and 2009 they were doing just that. For example, Ecuador raised duties on 600 goods, Russia increased import tariffs on used cars, while India placed them on some sorts of steel imports.

According to the World Bank, however, two-thirds of the protectionist measures taken in 2008 and 2009 were various kinds of "non-tariff barriers that are designed to get around WTO rules." Indonesia, for example, specified that certain kinds of goods, including clothes, shoes, and toys, can be imported only through five ports. Since these ports have limited capacity, this constrains the ability of foreign companies to sell into the Indonesian market. Argentina has imposed discretionary licensing requirements on a range of goods including car parts, textiles, and televisions. If you can't get a license, you can't sell into Argentina. China has stopped a wide range of imports of food and drink products from Europe, citing safety rules and environmental concerns, while India has banned imports of toys from China for safety reasons.

Developed nations in general did not take similar actions, but they sharply increased subsidies to troubled domestic producers, which gave them an advantage against unsubsidized international competitors, and therefore may have distorted trade. The key example of this in 2008 and 2009 was the automobile industry. To protect national producers, hold on to jobs, and stave of bankruptcies, rich countries including the United States, Britain, Canada, France, Germany, Italy, and Sweden gave over $45 billion in subsidies to car companies between mid-2008 and mid-2009. The problem with such subsidies is that they could cause production to switch from more efficient plants to less efficient plants that have an advantage due to state support. Although the WTO has rules against trade-distorting subsidies, its enforcement mechanisms are weaker than in the case of tariffs, and so far countries that have been increasing subsidies have not been challenged.

The volume of international trade has since rebounded strongly, growing by around 14.5 percent on the back of a 3.1 percent increase in the size of the global economy in 2010. As this happened, protectionist pressures abated somewhat. Trade rebounded more strongly in developing nations than in the developed world. China, in particularly, saw a massive 28.5 percent leap in the volume of its exports, which created additional trade tensions.[57]

Case Discussion Questions

1. Why do you think calls for protectionism are greater during sharp economic contractions than during boom periods?
2. Despite the sharp economic contraction during 2008–2009, the increase in protectionist measures was fairly modest. Why do you think this was the case?
3. During 2008–2009 many developed nations gave subsidies to their automobile producers. How might this have distorted international trade? Was this a reasonable thing to do given the circumstances?
4. What might occur if a renewed economic slowdown triggered a wave of protectionist measures

around the world? Would protectionism actually protect jobs, or would it make things worse?

5. The volume of world trade rebounded sharply in 2010 on the back of a fairly modest growth rate in the world economy. What does this tell you about the nature of international production in today's global economy? What does this tell you about the vulnerability of the world economy to any future trade wars?

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8 Foreign Direct Investment

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Recognize current trends regarding foreign direct investment (FDI) in the world economy.
- **LO2** Explain the different theories of FDI.
- **LO3** Understand how political ideology shapes a government's attitudes toward FDI.
- **LO4** Describe the benefits and costs of FDI to home and host countries.
- **LO5** Explain the range of policy instruments that governments use to influence FDI.
- **LO6** Identify the implications for managers of the theory and government policies associated with FDI.

Walmart in Japan

Japan has been a tough market for foreign firms to enter. The level of foreign direct investment (FDI) in Japan is a fraction of that found in many other developed nations. In 2008, for example, the stock of foreign direct investment as a percentage of GDP was 4.1 percent in Japan. In the United States, the comparable figure was 16 percent, in Germany 19.2 percent, in France 34.7 percent, and in the United Kingdom 36.9 percent.

Various reasons account for the lack of FDI into Japan. Until the 1990s, government regulations made it difficult for companies to establish a direct presence in the nation. In the retail sector, for example, the Large Scale Retail Store Law, which was designed to protect politically powerful small retailers, made it all but impossible for foreign retailers to open large-volume stores in the country (the law was repealed in 1994). Despite deregulation during the 1990s, FDI into Japan remained at low levels. Some cite cultural factors in explaining this. Many Japanese companies have resisted acquisitions by foreign enterprises (acquisitions are a major vehicle for FDI). They did so because of fears that new owners would restructure too harshly, cutting jobs and breaking long-standing commitments with suppliers. Foreign investors also state that it is difficult to find managerial talent in Japan. Most managers tend to stay with a single employer for their entire career, leaving very few managers in the labor market for foreign firms to hire. Furthermore, a combination of slow economic growth, sluggish consumer spending, and an aging population makes the Japanese economy less attractive than it once was, particularly when compared to the dynamic and rapidly growing economies of India and China, or even the United States and the United Kingdom.

The Japanese government, however, has come around to the view that the country needs more foreign investment. Foreign firms can bring competition to Japan where local ones may not because the foreign firms do not feel bound by existing business practices or relationships. They can be a source of new management



ideas, business policies, and technology, all of which boost productivity. Indeed, a study by the Organization for Economic Cooperation and Development (OECD) suggests that labor productivity at the Japanese affiliates of foreign firms is as much as 60 percent higher than at domestic firms, and in services firms it is as much as 80 percent higher.

It was the opportunity to help restructure Japan's retail sector, boosting productivity, gaining market share, and profiting in the process, that attracted Walmart to Japan. The world's largest retailer, Walmart entered Japan in 2002 by acquiring a stake in Seiyu, which was then the fifth-largest retailer in Japan. Under the terms of the deal, Walmart increased its ownership stake over the next five years, becoming a majority owner by 2006. Seiyu was by all accounts an inefficient retailer. According to one top officer, "Seiyu is bogged down in old customs that are wasteful. Walmart brings proven skills in managing big supermarkets, which is what we would like to learn to do."

Walmart's goal was to transfer best practices from its U.S. stores and use them to improve the performance of Seiyu. This meant implementing Walmart's cutting-edge information systems, adopting tight inventory control, leveraging its global supply chain to bring low-cost goods into Japan, introducing everyday low prices, retraining employees to improve customer service, extending opening hours, renovating stores, and investing in new ones.

It proved to be more difficult than Walmart had hoped. Walmart's entry prompted local rivals to change their strategies. They began to make acquisitions and started to cut their prices to match Walmart's discounting strategy. Walmart also found that it had to alter its merchandising approach, offering more high-value items to match Japanese shopping habits, which were proving to be difficult to change. Also, many Japanese suppliers were reluctant to work closely with Walmart. Despite this, after years of losses it looked as if Seiyu would become profitable in 2010, indicating that Walmart might be able to ultimately reap a return on its investment.[1]

Introduction

Foreign direct investment (FDI) occurs when a firm invests directly in facilities to produce or market a product in a foreign country. According to the U.S. Department of Commerce, FDI occurs whenever a U.S. citizen, organization, or affiliated group takes an interest of 10 percent or more in a foreign business entity. Once a firm undertakes FDI, it becomes a *multinational enterprise*. An example of FDI is given in the opening case about Walmart's investment in Japan. Walmart first became a multinational in the early 1990s when it invested in Mexico.

FDI takes on two main forms. The first is a **greenfield investment**, which involves the establishment of a new operation in a foreign country. The second involves acquiring or merging with an existing firm in the foreign country (Walmart's entry into Japan was in the form of an acquisition). Acquisitions can be a minority (where the foreign firm takes a 10 percent to 49 percent interest in the firm's voting stock), majority (foreign interest of 50 percent to 99 percent), or full outright stake (foreign interest of 100 percent).[2]

This chapter opens by looking at the importance of foreign direct investment in the world economy. Next, it reviews the theories that have been used to explain foreign direct investment. The chapter then moves on to look at government policy toward foreign direct investment and closes with a section on implications for business.

LO1 Foreign Direct Investment in the World Economy

When discussing foreign direct investment, it is important to distinguish between the flow of FDI and the stock of FDI. The **flow of FDI** refers to the amount of FDI undertaken over a given time period (normally a year). The **stock of FDI** refers to the total accumulated value of foreign-owned assets at a given time. We also talk of **outflows of FDI**, meaning the flow of FDI out of a country, and **inflows of FDI**, the flow of FDI into a country.

TRENDS IN FDI

The past 30 years have seen a marked increase in both the flow and stock of FDI in the world economy. The average yearly outflow of FDI increased from $25 billion in 1975 to a record $1.8 trillion in 2007 (see Figure 8.1). However, FDI outflows did contract to $1.1 trillion in 2009 and 2010 in the wake of the global financial crisis, although they were forecasted to recover in 2011.[3] In general, however, over the past 30 years the flow of FDI has accelerated faster than the growth in world trade and world output. For example, between 1992 and 2008, the total flow of FDI from all countries increased more than eightfold while world trade by value grew by some 150 percent and world output by around 45 percent.[4] As a result of the strong FDI flow, by 2009 the global stock of FDI was about $15.5 trillion. At least 82,000 parent companies had 810,000 affiliates in foreign markets that collectively employed more than 77 million people abroad and generated value accounting for about 11 percent of global GDP. The foreign affiliates of multinationals had more than $30 trillion in global sales, higher than the value of global exports of goods and services, which stood at close to $19.9 trillion.[5]

FDI has grown more rapidly than world trade and world output for several reasons. First, despite the general decline in trade barriers over the past 30 years, firms still fear protectionist pressures. Executives see FDI as a way of circumventing future trade barriers. Second, much of the increase in FDI has been driven by the political and economic changes that have been occurring in many of the world's developing nations. The general shift toward democratic political institutions and free market economies that we discussed in Chapter 3 has encouraged FDI. Across much of Asia, Eastern Europe, and

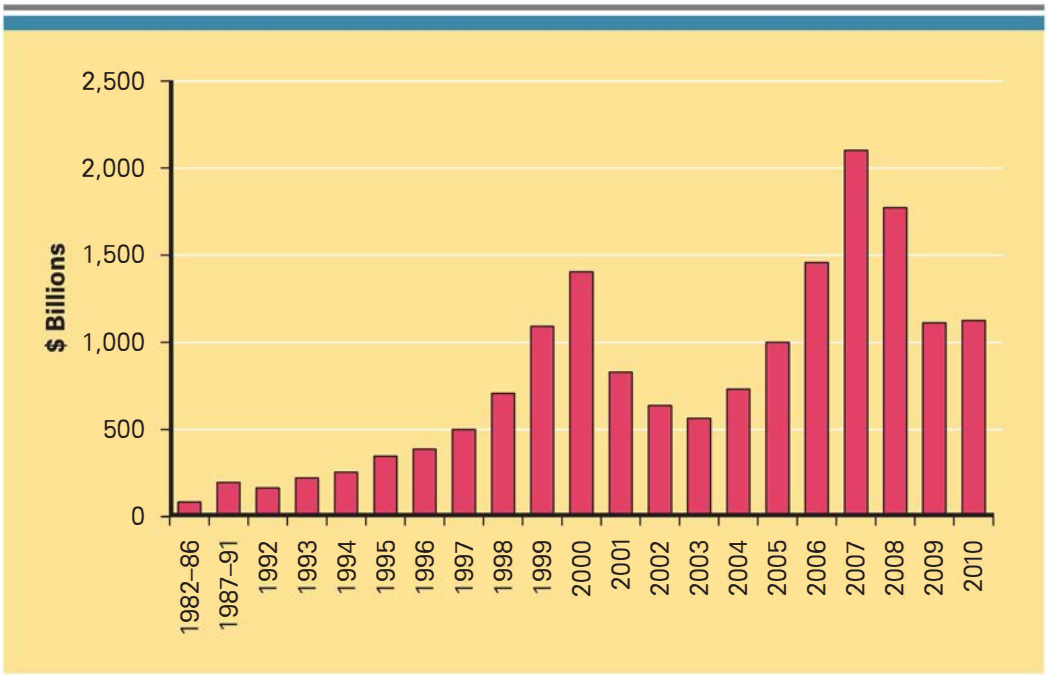


FIGURE 8.1

FDI Outflows, 1982–2010 ($ billions)

Source: Constructed by the author from data in United Nations, *World Investment Report, 2009* (New York and Geneva: United Nations, 2009).

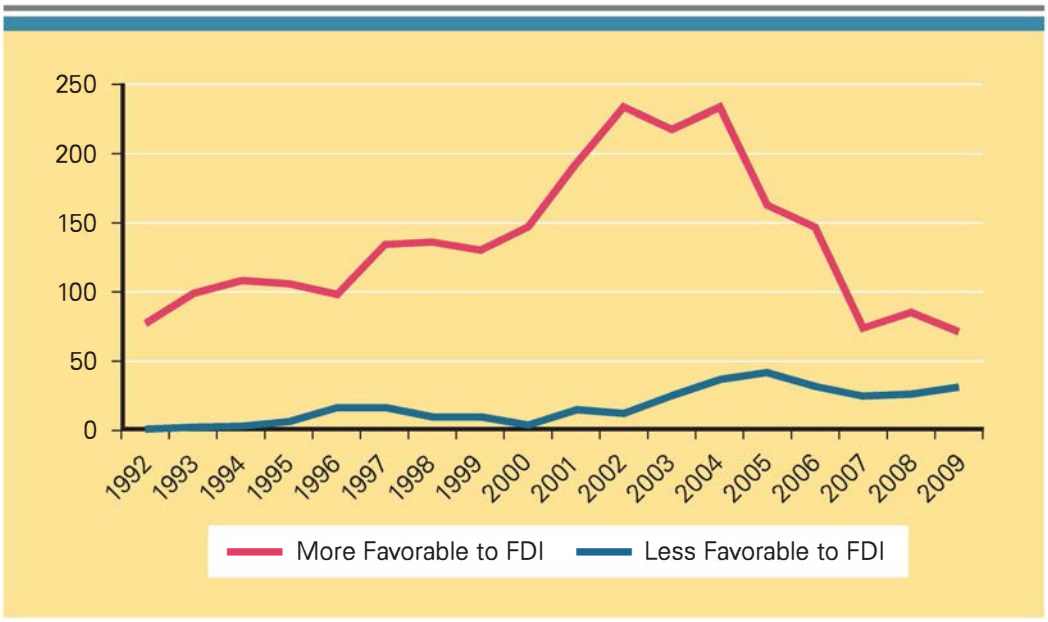


FIGURE 8.2

National Regulatory Changes Governing FDI, 1992–2009

Source: Constructed by the author from data in United Nations, *World Investment Report*, various editions.

Latin America, economic growth, economic deregulation, privatization programs that are open to foreign investors, and removal of many restrictions on FDI have made these countries more attractive to foreign multinationals. According to the United Nations, some 90 percent of the 2,700 changes made worldwide between 1992 and 2009 in the laws governing foreign direct investment created a more favorable environment for FDI (see Figure 8.2).[6] However, since the early 2000s the number of regulations that are less favorable toward FDI has increased, suggesting the pendulum may be starting to swing the other way. In Latin America, in particular, two-thirds of the reported changes in 2005 and 2009 made the environment for foreign direct investment less welcome. Most of these unfavorable changes were focused on extractive industries, such as oil and gas, where governments seemed focused on limiting FDI and capturing more of the economic value from FDI through, for example, higher taxes and royalty rates applied to foreign enterprises.

Notwithstanding recent adverse developments in some nations, the general desire of governments to facilitate FDI also has been reflected in a sharp increase in the number of bilateral investment treaties designed to protect and promote investment between two countries. As of 2009, 2,676 such treaties involved more than 180 countries, a nearly 15-fold increase from the 181 treaties that existed in 1980.[7]

The globalization of the world economy is also having a positive impact on the volume of FDI. Many firms such as Walmart (profiled in the opening case) now see the whole world as their market, and they are undertaking FDI in an attempt to make sure they have a significant presence in many regions of the world. For reasons that we shall explore later in this book, many firms now believe it is important to have production facilities based close to their major customers. This, too, creates pressure for greater FDI.

THE DIRECTION OF FDI

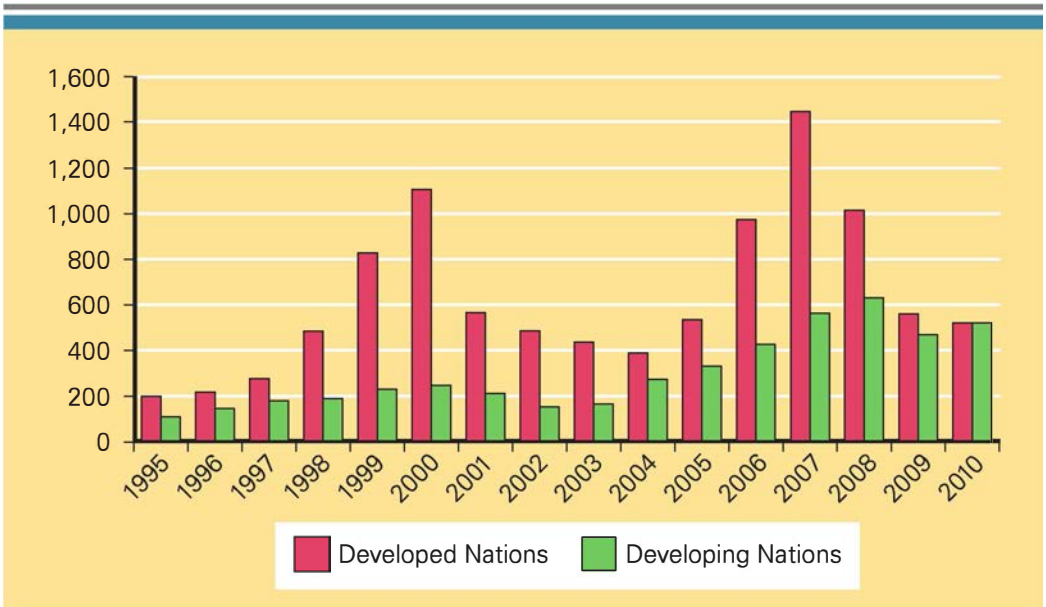
Historically, most FDI has been directed at the developed nations of the world as firms based in advanced countries invested in the others' markets (see Figure 8.3). During the 1980s and 1990s, the United States was often the favorite target for FDI inflows. The United States has been an attractive target for FDI because of its large and wealthy domestic markets, its dynamic and stable economy, a favorable political environment, and the openness of the country to FDI. Investors include firms based in Great Britain, Japan, Germany, Holland, and France. Inward investment into the United States remained high during the 2000s, totaling $324 billion in 2008, although it fell to $1,860 billion in 2010 in the wake of the global financial crisis. The developed nations of the European Union have also been recipients of significant FDI inflows, principally from U.S. and Japanese enterprises and from other member states of the EU. In 2007, inward investment into the EU reached a record $923 billion, although it fell to $289 billion in 2010. The United Kingdom and France have historically been the largest recipients of inward FDI.

Even though developed nations still account for the largest share of FDI inflows, FDI into developing nations has increased (see Figure 8.3). From 1985 to 1990, the annual inflow of FDI into developing nations averaged $27.4 billion, or 17.4 percent of the total global flow. In the mid- to late 1990s, the inflow into developing nations was generally between 35 and 40 percent of the total, before falling back to account for about 25 percent of the total in the 2000–02 period and then climbing to hit a record 50 percent in 2010. Most recent inflows into developing nations have been targeted at the emerging economies of South, East, and Southeast Asia. Driving much of the increase has been

FIGURE 8.3

FDI Inflows by Region, 1995–2010 ($ billions)

Source: Constructed by the author from data in United Nations, *World Investment Report*, various editions.



the growing importance of China as a recipient of FDI, which attracted about $60 billion of FDI in 2004 and rose steadily to hit $101 billion in 2010.[8] The reasons for the strong flow of investment into China are discussed in the accompanying Country Focus.

Latin America emerged as the next most important region in the developing world for FDI inflows. In 2008, total inward investments into this region reached about $141 billion. Mexico and Brazil have historically been the two top recipients of inward FDI in Latin America, a trend that continued in the late 2000s. At the other end of the scale, Africa has long received the smallest amount of inward investment; although the continent did receive a record $72 billion in 2008, investment slumped to $50 billion in 2010. In recent years, Chinese enterprises have emerged as major investors in Africa, particularly in extraction industries where they seem to be trying to assure future supplies of valuable raw materials. The inability of Africa to attract greater investment is in part a reflection of the political unrest, armed conflict, and frequent changes in economic policy in the region.[9]

Another way of looking at the importance of FDI inflows is to express them as a percentage of gross fixed capital formation. **Gross fixed capital formation** summarizes the total amount of capital invested in factories, stores, office buildings, and the like. Other things being equal, the greater the capital investment in an economy, the more favorable its future growth prospects are likely to be. Viewed this way, FDI can be seen as an important source of capital investment and a determinant of the future growth rate of an economy. Figure 8.4 summarizes inward flows of FDI as a percentage of gross fixed capital formation for developed and developing economies for 1992–2008. During 1992–1997, FDI flows accounted for about 4 percent of gross fixed capital formation in developed nations and 8 percent in developing nations. By 2006–2008, the figure was 14 percent worldwide, suggesting that FDI had become an increasingly important source of investment in the world's economies.

These gross figures hide important individual country differences. For example, in 2008, inward FDI accounted for some 47 percent of gross fixed capital formation in Sweden and 21 percent in the UK, but 2.3 percent in Venezuela and 2.2 percent in Japan—suggesting that FDI is an important source of investment capital, and thus economic growth, in the first two countries but not the latter two. These differences can be explained by several factors, including the perceived ease and attractiveness of investing in a nation. To the extent that burdensome regulations limit the opportunities for foreign investment in countries such as Japan and Venezuela, these nations may be hurting themselves by limiting their access to needed capital investments (see the opening case for more details on Japan).

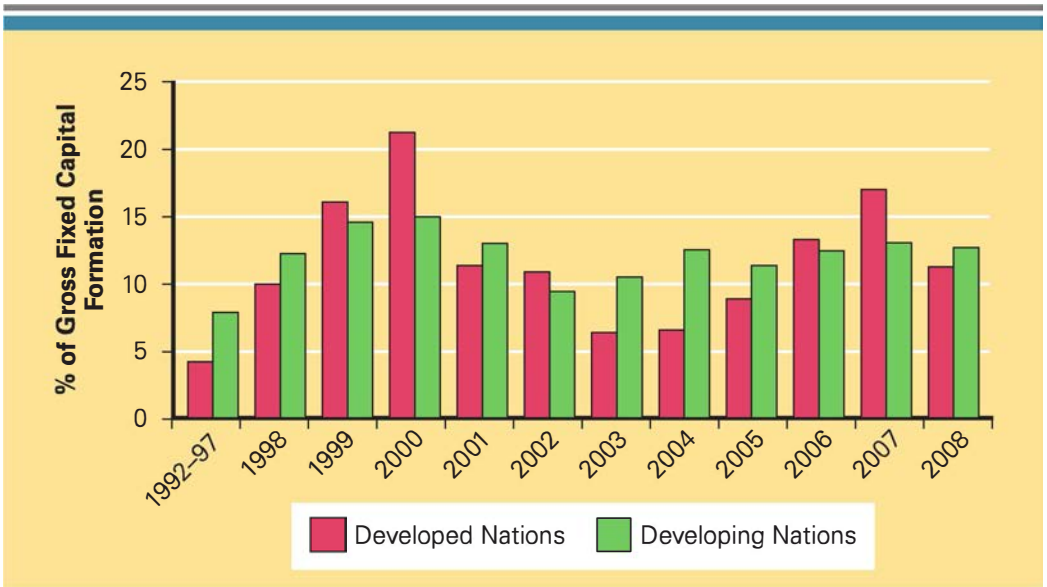


FIGURE 8.4

Inward FDI as a Percent of Gross Fixed Capital Formation, 1992–2008

Source: Constructed by the author from data in United Nations, *World Investment Report*, various editions.

Foreign Direct Investment in China

Beginning in late 1978, China's leadership decided to move the economy away from a centrally planned socialist system to one that was more market driven. The result has been nearly three decades of sustained high economic growth rates of about 10 percent annually compounded. This rapid growth has attracted substantial foreign investment. Starting from a tiny base, foreign investment increased to an annual average rate of $2.7 billion between 1985 and 1990 and then surged to $40 billion annually in the late 1990s, making China the second-biggest recipient of FDI inflows in the world after the United States. By the late 2000s, China was attracting between $80 billion and $100 billion of FDI annually, with another $60 billion a year going into Hong Kong.

Over the past 20 years, this inflow has resulted in the establishment of more than 300,000 foreign-funded enterprises in China. The total stock of FDI in mainland China grew from effectively zero in 1978 to $378 billion in 2008 (another $835 billion of FDI stock was in Hong Kong). FDI amounted to about 8 percent of annualized gross fixed capital formation in China between 1998 and 2008, suggesting that FDI is an important source of economic growth in China.

The reasons for the investment are fairly obvious. With a population of more than 1.3 billion people, China represents the world's largest market. Historically, import tariffs made it difficult to serve this market via exports, so FDI was required if a company wanted to tap into the country's huge potential. Although China joined the World Trade Organization in 2001, which will ultimately mean a reduction in import tariffs, this will occur slowly, so this motive for investing in China will persist. Also, many foreign firms believe that doing business in China requires a substantial presence in the country to build *guanxi,* the crucial relationship networks (see Chapter 4 for details). Furthermore, a combination of cheap labor and tax incentives, particularly for enterprises that establish themselves in special economic zones, makes China an attractive base from which to serve Asian or world markets with exports.

Less obvious, at least to begin with, was how difficult it would be for foreign firms to do business in China. Blinded by the size and potential of China's market, many firms have paid less attention than perhaps they should have to the complexities of operating a business in this country until after the investment has been made. China may have a huge population, but despite two decades of rapid growth, it is still relatively poor. The lack of purchasing power translates into relatively weak markets for many Western consumer goods. Another problem is the lack of a well-developed transportation infrastructure or distribution system outside of major urban areas. PepsiCo discovered this problem at its subsidiary in Chongqing. Perched above the Yangtze River in southwest Sichuan province, Chongqing lies at the heart of China's massive hinterland. The Chongqing municipality, which includes the city and its surrounding regions, contains more than 30 million people, but according to Steve Chen, the manager of the PepsiCo subsidiary, the lack of well-developed road and distribution systems means he can reach only about half of this population with his product.

Other problems include a highly regulated environment, which can make it problematic to conduct business transactions, and shifting tax and regulatory regimes. For example, a few years ago, the Chinese government suddenly scrapped a tax credit scheme that had made it attractive to import capital equipment into China. This immediately made it more expensive to set up operations in the country. Then there are problems with local joint-venture partners that are inexperienced, opportunistic, or simply operate according to different goals. One U.S. manager explained that when he laid off 200 people to reduce costs, his Chinese partner hired them all back the next day. When he inquired why they had been hired back, the executive of the Chinese partner, which was government owned, explained that as an agency of the government, it had an "obligation" to reduce unemployment.

To continue to attract foreign investment, the Chinese government has committed itself to invest more than $800 billion in infrastructure projects over 10 years. This should improve the nation's poor highway system. By giving preferential tax breaks to companies that invest in special regions, such as that around Chongqing, the Chinese have created incentives for foreign companies to invest in China's vast interior where markets are underserved. They have been pursuing a macroeconomic policy that includes an emphasis on maintaining steady economic growth, low inflation, and a stable currency, all of which are attractive to foreign investors. Given these developments, it seems likely that the country will continue to be an important magnet for foreign investors well into the future.[10]

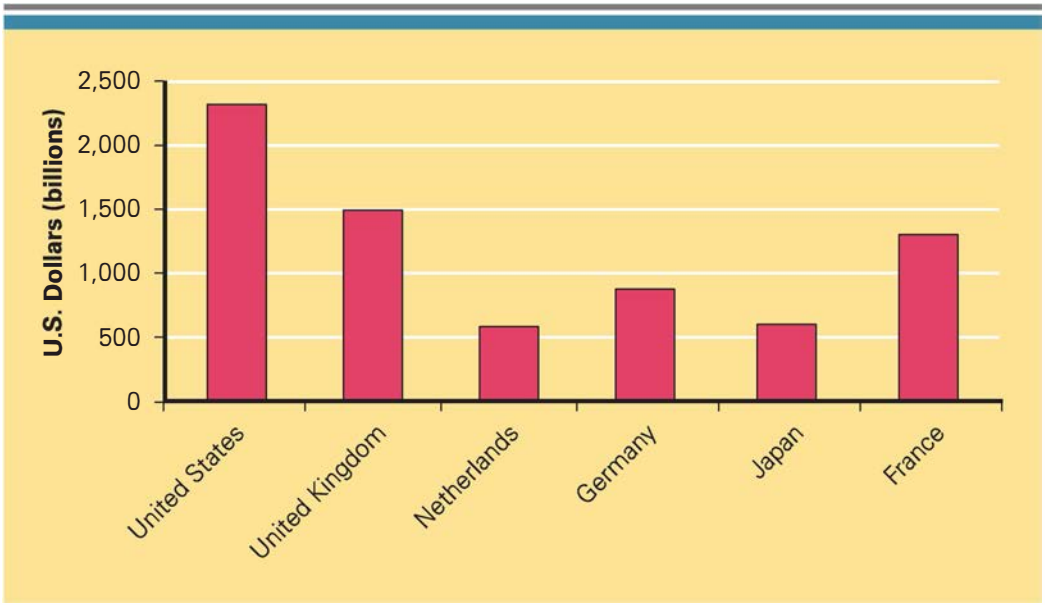


FIGURE 8.5

Cumulative FDI Outflows, 1998–2010 ($ billions)

Source: Constructed by the author from data in United Nations, *World Investment Report*, various editions.

Note: Share accounted for by the United States would have been larger were it not for significant onetime investment inflows in 2005 due to changes in U.S. tax laws.

THE SOURCE OF FDI

Since World War II, the United States has been the largest source country for FDI, a position it retained during the late 1990s and early 2000s. Other important source countries include the United Kingdom, France, Germany, the Netherlands, and Japan. Collectively, these six countries accounted for 60 percent of all FDI outflows for 1998–2010 (see Figure 8.5). As might be expected, these countries also predominate in rankings of the world's largest multinationals.[11] These nations dominate primarily because they were the most developed nations with the largest economies during much of the postwar period and therefore home to many of the largest and best-capitalized enterprises. Many of these countries also had a long history as trading nations and naturally looked to foreign markets to fuel their economic expansion. Thus, it is no surprise that enterprises based there have been at the forefront of foreign investment trends.

THE FORM OF FDI: ACQUISITIONS VERSUS GREENFIELD INVESTMENTS

FDI can take the form of a greenfield investment in a new facility or an acquisition of or a merger with an existing local firm. The majority of cross-border investment is in the form of mergers and acquisitions rather than greenfield investments. UN estimates indicate that some 40 to 80 percent of all FDI inflows were in the form of mergers and acquisitions between 1998 and 2009. In 2001, for example, mergers and acquisitions accounted for some 78 percent of all FDI inflows. In 2004, the figure was 59 percent, while in 2008 it was 40 percent, although the figure slumped to just 22 percent in 2009 reflecting the impact of the global financial crisis and the difficulties of financing acquisitions through the public capital markets.[12] However, FDI flows into developed nations differ markedly from those into developing nations. In the case of developing nations, only about one-third of FDI is in the form of cross-border mergers and acquisitions. The lower percentage of mergers and acquisitions may simply reflect the fact that there are fewer target firms to acquire in developing nations.

When contemplating FDI, why do firms apparently prefer to acquire existing assets rather than undertake greenfield investments? We shall consider it in greater depth in Chapter 15; for now we will make only a few basic observations. First, mergers and acquisitions are quicker to execute than greenfield investments. This is an important consideration in the modern business world where markets evolve very rapidly. Many firms apparently believe that if they do not acquire a desirable target firm, then their global

rivals will. Second, foreign firms are acquired because those firms have valuable strategic assets, such as brand loyalty, customer relationships, trademarks or patents, distribution systems, production systems, and the like. It is easier and perhaps less risky for a firm to acquire those assets than to build them from the ground up through a greenfield investment. Third, firms make acquisitions because they believe they can increase the efficiency of the acquired unit by transferring capital, technology, or management skills. However, there is evidence that many mergers and acquisitions fail to realize their anticipated gains.[13]

LO2 Theories of Foreign Direct Investment

In this section, we review several theories of foreign direct investment. These theories approach the various phenomena of foreign direct investment from three complementary perspectives. One set of theories seeks to explain why a firm will favor direct investment as a means of entering a foreign market when two other alternatives, exporting and licensing, are open to it. Another set of theories seeks to explain why firms in the same industry often undertake foreign direct investment at the same time, and why they favor certain locations over others as targets for foreign direct investment. Put differently, these theories attempt to explain the observed *pattern* of foreign direct investment flows. A third theoretical perspective, known as the **eclectic paradigm**, attempts to combine the two other perspectives into a single holistic explanation of foreign direct investment (this theoretical perspective is *eclectic* because the best aspects of other theories are taken and combined into a single explanation).

WHY FOREIGN DIRECT INVESTMENT?

Why do firms go to all of the trouble of establishing operations abroad through foreign direct investment when two alternatives, exporting and licensing, are available to them for exploiting the profit opportunities in a foreign market? **Exporting** involves producing goods at home and then shipping them to the receiving country for sale. **Licensing** involves granting a foreign entity (the licensee) the right to produce and sell the firm's product in return for a royalty fee on every unit sold. The question is important, given that a cursory examination of the topic suggests that foreign direct investment may be both expensive and risky compared with exporting and licensing. FDI is expensive because a firm must bear the costs of establishing production facilities in a foreign country or of acquiring a foreign enterprise. FDI is risky because of the problems associated with doing business in a different culture where the rules of the game may be very different. Relative to indigenous firms, there is a greater probability that a foreign firm undertaking FDI in a country for the first time will make costly mistakes due to its ignorance. When a firm exports, it need not bear the costs associated with FDI, and it can reduce the risks associated with selling abroad by using a native sales agent. Similarly, when a firm allows another enterprise to produce its products under license, the licensee bears the costs or risks. So why do so many firms apparently prefer FDI over either exporting or licensing? The answer can be found by examining the limitations of exporting and licensing as means for capitalizing on foreign market opportunities.

Limitations of Exporting

The viability of an exporting strategy is often constrained by transportation costs and trade barriers. When transportation costs are added to production costs, it becomes unprofitable to ship some products over a large distance. This is particularly true of products that have a low value-to-weight ratio and that can be produced in almost any location. For such products, the attractiveness of exporting decreases, relative to either FDI or licensing. This is the case, for example, with cement. Thus Cemex, the large Mexican cement maker, has expanded internationally by pursuing FDI, rather than exporting (see the accompanying Management Focus on Cemex). For products with a high



Foreign Direct Investment by Cemex

In little more than a decade, Mexico's largest cement manufacturer, Cemex, has transformed itself from a primarily Mexican operation into the third-largest cement company in the world behind Holcim of Switzerland and Lafarge Group of France. Cemex has long been a powerhouse in Mexico and currently controls more than 60 percent of the market for cement in that country. Cemex's domestic success has been based in large part on an obsession with efficient manufacturing and a focus on customer service that is tops in the industry.

Cemex is a leader in using information technology to match production with consumer demand. The company sells ready-mixed cement that can survive for only about 90 minutes before solidifying, so precise delivery is important. But Cemex can never predict with total certainty what demand will be on any given day, week, or month. To better manage unpredictable demand patterns, Cemex developed a system of seamless information technology, including truck-mounted global positioning systems, radio transmitters, satellites, and computer hardware, that allows it to control the production and distribution of cement like no other company can, responding quickly to unanticipated changes in demand and reducing waste. The results are lower costs and superior customer service, both differentiating factors for Cemex.

The company also pays lavish attention to its distributors—some 5,000 in Mexico alone—who can earn points toward rewards for hitting sales targets. The distributors can then convert those points into Cemex stock. High-volume distributors can purchase trucks and other supplies through Cemex at significant discounts. Cemex also is known for its marketing drives that focus on end users, the builders themselves. For example, Cemex trucks drive around Mexican building sites, and if Cemex cement is being used, the construction crews win soccer balls, caps, and T-shirts.

Cemex's international expansion strategy was driven by a number of factors. First, the company wished to reduce its reliance on the Mexican construction market, which was characterized by very volatile demand. Second, the company realized there was tremendous demand for cement in many developing countries, where significant construction was being undertaken or needed. Third, the company believed that it understood the needs of construction businesses in developing nations better than the established multinational cement companies, all of which were from developed nations. Fourth, Cemex believed that it could create significant value by acquiring inefficient cement companies in other markets and transferring its skills in customer service, marketing, information technology, and production management to those units.

The company embarked in earnest on its international expansion strategy in the early 1990s. Initially, Cemex targeted other developing nations, acquiring established cement makers in Venezuela, Colombia, Indonesia, the Philippines, Egypt, and several other countries. It also purchased two stagnant companies in Spain and turned them around. Bolstered by the success of its Spanish ventures, Cemex began to look for expansion opportunities in developed nations. In 2000, Cemex purchased Houston-based Southland, one of the largest cement companies in the United States, for $2.5 billion. Following the Southland acquisition, Cemex had 56 cement plants in 30 countries, most of which were gained through acquisitions. In all cases, Cemex devoted great attention to transferring its technological, management, and marketing know-how to acquired units, thereby improving their performance.

In 2004, Cemex made another major foreign investment move, purchasing RMC of Great Britain for $5.8 billion. RMC was a huge multinational cement firm with sales of $8 billion, only 22 percent of which were in the United Kingdom, and operations in more than 20 other nations, including many European nations where Cemex had no presence. Finalized in March 2005, the RMC acquisition has transformed Cemex into a global powerhouse in the cement industry with more than $15 billion in annual sales and operations in 50 countries. Only about 15 percent of the company's sales are now generated in Mexico. Following the acquisition of RMC, Cemex found that the RMC plant in Rugby was running at only 70 percent of capacity, partly because repeated production problems kept causing a kiln shutdown. Cemex brought in an international team of specialists to fix the problem and quickly increased production to 90 percent of capacity. Going forward, Cemex has made it clear that it will continue to expand and is eyeing opportunities in the fast-growing economies of China and India where currently it lacks a presence, and where its global rivals are already expanding.[14]

value-to-weight ratio, however, transportation costs are normally a minor component of total landed cost (e.g., electronic components, personal computers, medical equipment, computer software, etc.) and have little impact on the relative attractiveness of exporting, licensing, and FDI.

Transportation costs aside, some firms undertake foreign direct investment as a response to actual or threatened trade barriers such as import tariffs or quotas. By placing tariffs on imported goods, governments can increase the cost of exporting relative to foreign direct investment and licensing. Similarly, by limiting imports through quotas, governments increase the attractiveness of FDI and licensing. For example, the wave of FDI by Japanese auto companies in the United States during the 1980s and 1990s was partly driven by protectionist threats from Congress and by quotas on the importation of Japanese cars. For Japanese auto companies, these factors decreased the profitability of exporting and increased that of foreign direct investment. In this context, it is important to understand that trade barriers do not have to be physically in place for FDI to be favored over exporting. Often, the desire to reduce the threat that trade barriers might be imposed is enough to justify foreign direct investment as an alternative to exporting.

Limitations of Licensing

A branch of economic theory known as **internalization theory** seeks to explain why firms often prefer foreign direct investment over licensing as a strategy for entering foreign markets (this approach is also known as the **market imperfections** approach).[15] According to internalization theory, licensing has three major drawbacks as a strategy for exploiting foreign market opportunities. First, *licensing may result in a firm's giving away valuable technological know-how to a potential foreign competitor*. For example, in the 1960s, RCA licensed its leading-edge color television technology to a number of Japanese companies, including Matsushita and Sony. At the time, RCA saw licensing as a way to earn a good return from its technological know-how in the Japanese market without the costs and risks associated with foreign direct investment. However, Matsushita and Sony quickly assimilated RCA's technology and used it to enter the U.S. market to compete directly against RCA. As a result, RCA is now a minor player in its home market, while Matsushita and Sony have a much bigger market share.

A second problem is that *licensing does not give a firm the tight control over manufacturing, marketing, and strategy in a foreign country that may be required to maximize its profitability*. With licensing, control over manufacturing, marketing, and strategy are granted to a licensee in return for a royalty fee. However, for both strategic and operational reasons, a firm may want to retain control over these functions. The rationale for wanting control over the strategy of a foreign entity is that a firm might want its foreign subsidiary to price and market very aggressively as a way of keeping a foreign competitor in check. Unlike a wholly owned subsidiary, a licensee would probably not accept such an imposition, because it would likely reduce the licensee's profit, or it might even cause the licensee to take a loss.

The rationale for wanting control over the operations of a foreign entity is that the firm might wish to take advantage of differences in factor costs across countries, producing only part of its final product in a given country, while importing other parts from elsewhere where they can be produced at lower cost. Again, a licensee would be unlikely to accept such an arrangement, since it would limit the licensee's autonomy. Thus, for these reasons, when tight control over a foreign entity is desirable, foreign direct investment is preferable to licensing.

A third problem with licensing arises when the firm's competitive advantage is based not as much on its products as on the management, marketing, and manufacturing capabilities that produce those products. The problem here is that *such capabilities are often not amenable to licensing*. While a foreign licensee may be able to physically reproduce the firm's product under license, it often may not be able to do so as efficiently as the firm

could itself. As a result, the licensee may not be able to fully exploit the profit potential inherent in a foreign market.

For example, consider Toyota, a company whose competitive advantage in the global auto industry is acknowledged to come from its superior ability to manage the overall process of designing, engineering, manufacturing, and selling automobiles, that is, from its management and organizational capabilities. Indeed, Toyota is credited with pioneering the development of a new production process, known as *lean production*, that enables it to produce higher-quality automobiles at a lower cost than its global rivals.[16] Although Toyota could license certain products, its real competitive advantage comes from its management and process capabilities. These kinds of skills are difficult to articulate or codify; they certainly cannot be written down in a simple licensing contract. They are organizationwide and have been developed over the years. They are not embodied in any one individual but instead are widely dispersed throughout the company. Put another way, Toyota's skills are embedded in its organizational culture, and culture is something that cannot be licensed. Thus, if Toyota were to allow a foreign entity to produce its cars under license, the chances are that the entity could not do so as efficiently as could Toyota. In turn, this would limit the ability of the foreign entity to fully develop the market potential of that product. Such reasoning underlies Toyota's preference for direct investment in foreign markets, as opposed to allowing foreign automobile companies to produce its cars under license.

All of this suggests that when one or more of the following conditions holds, markets fail as a mechanism for selling know-how and FDI is more profitable than licensing: (1) when the firm has valuable know-how that cannot be adequately protected by a licensing contract; (2) when the firm needs tight control over a foreign entity to maximize its market share and earnings in that country; and (3) when a firm's skills and know-how are not amenable to licensing.

Advantages of Foreign Direct Investment

It follows that a firm will favor foreign direct investment over exporting as an entry strategy when transportation costs or trade barriers make exporting unattractive. Furthermore, the firm will favor foreign direct investment over licensing (or franchising) when it wishes to maintain control over its technological know-how, or over its operations and business strategy, or when the firm's capabilities are simply not amenable to licensing, as may often be the case.

THE PATTERN OF FOREIGN DIRECT INVESTMENT

Observation suggests that firms in the same industry often undertake foreign direct investment at about the same time. Also, firms tend to direct their investment activities toward certain locations. The two theories we consider in this section attempt to explain the patterns that we observe in FDI flows.

Strategic Behavior

One theory is based on the idea that FDI flows are a reflection of strategic rivalry between firms in the global marketplace. An early variant of this argument was expounded by F. T. Knickerbocker, who looked at the relationship between FDI and rivalry in oligopolistic industries.[17] An **oligopoly** is an industry composed of a limited number of large firms (e.g., an industry in which four firms control 80 percent of a domestic market would be defined as an oligopoly). A critical competitive feature of such industries is interdependence of the major players: What one firm does can have an immediate impact on the major competitors, forcing a response in kind. By cutting prices, one firm in an oligopoly can take market share away from its competitors, forcing them to respond with similar price cuts to retain their market share. Thus, the interdependence between

firms in an oligopoly leads to imitative behavior; rivals often quickly imitate what a firm does in an oligopoly.

Imitative behavior can take many forms in an oligopoly. One firm raises prices, the others follow; one expands capacity, and the rivals imitate lest they be left at a disadvantage in the future. Knickerbocker argued that the same kind of imitative behavior characterizes FDI. Consider an oligopoly in the United States in which three firms—A, B, and C—dominate the market. Firm A establishes a subsidiary in France. Firms B and C decide that if successful, this new subsidiary may knock out their export business to France and give firm A a first-mover advantage. Furthermore, firm A might discover some competitive asset in France that it could repatriate to the United States to torment firms B and C on their native soil. Given these possibilities, firms B and C decide to follow firm A and establish operations in France.

Studies that looked at FDI by U.S. firms during the 1950s and 60s show that firms based in oligopolistic industries tended to imitate each other's FDI.[18] The same phenomenon has been observed with regard to FDI undertaken by Japanese firms during the 1980s.[19] For example, Toyota and Nissan responded to investments by Honda in the United States and Europe by undertaking their own FDI in the United States and Europe. More recently, research has shown that models of strategic behavior in a global oligopoly can explain the pattern of FDI in the global tire industry.[20]

Knickerbocker's theory can be extended to embrace the concept of multipoint competition. **Multipoint competition** arises when two or more enterprises encounter each other in different regional markets, national markets, or industries.[21] Economic theory suggests that rather like chess players jockeying for advantage, firms will try to match each other's moves in different markets to try to hold each other in check. The idea is to ensure that a rival does not gain a commanding position in one market and then use the profits generated there to subsidize competitive attacks in other markets. Kodak and Fuji Photo Film Co., for example, compete against each other around the world. If Kodak enters a particular foreign market, Fuji will not be far behind. Fuji feels compelled to follow Kodak to ensure that Kodak does not gain a dominant position in the foreign market that it could then leverage to gain a competitive advantage elsewhere. The converse also holds, with Kodak following Fuji when the Japanese firm is the first to enter a foreign market.

Although Knickerbocker's theory and its extensions can help to explain imitative FDI behavior by firms in oligopolistic industries, it does not explain why the first firm in an oligopoly decides to undertake FDI rather than to export or license. Internalization theory addresses this phenomenon. The imitative theory also does not address the issue of whether FDI is more efficient than exporting or licensing for expanding abroad. Again, internalization theory addresses the efficiency issue. For these reasons, many economists favor internalization theory as an explanation for FDI, although most would agree that the imitative explanation tells an important part of the story.

The Product Life Cycle

Raymond Vernon's product life-cycle theory, described in Chapter 6, also is used to explain FDI. Vernon argued that often the same firms that pioneer a product in their home markets undertake FDI to produce a product for consumption in foreign markets. Thus, Xerox introduced the photocopier in the United States, and it was Xerox that set up production facilities in Japan (Fuji–Xerox) and Great Britain (Rank–Xerox) to serve those markets. Vernon's view is that firms undertake FDI at particular stages in the life cycle of a product they have pioneered. They invest in other advanced countries when local demand in those countries grows large enough to support local production (as Xerox did). They subsequently shift production to developing countries when product standardization and market saturation give rise to price competition and cost pressures. Investment in developing countries, where labor costs are lower, is seen as the best way to reduce costs.

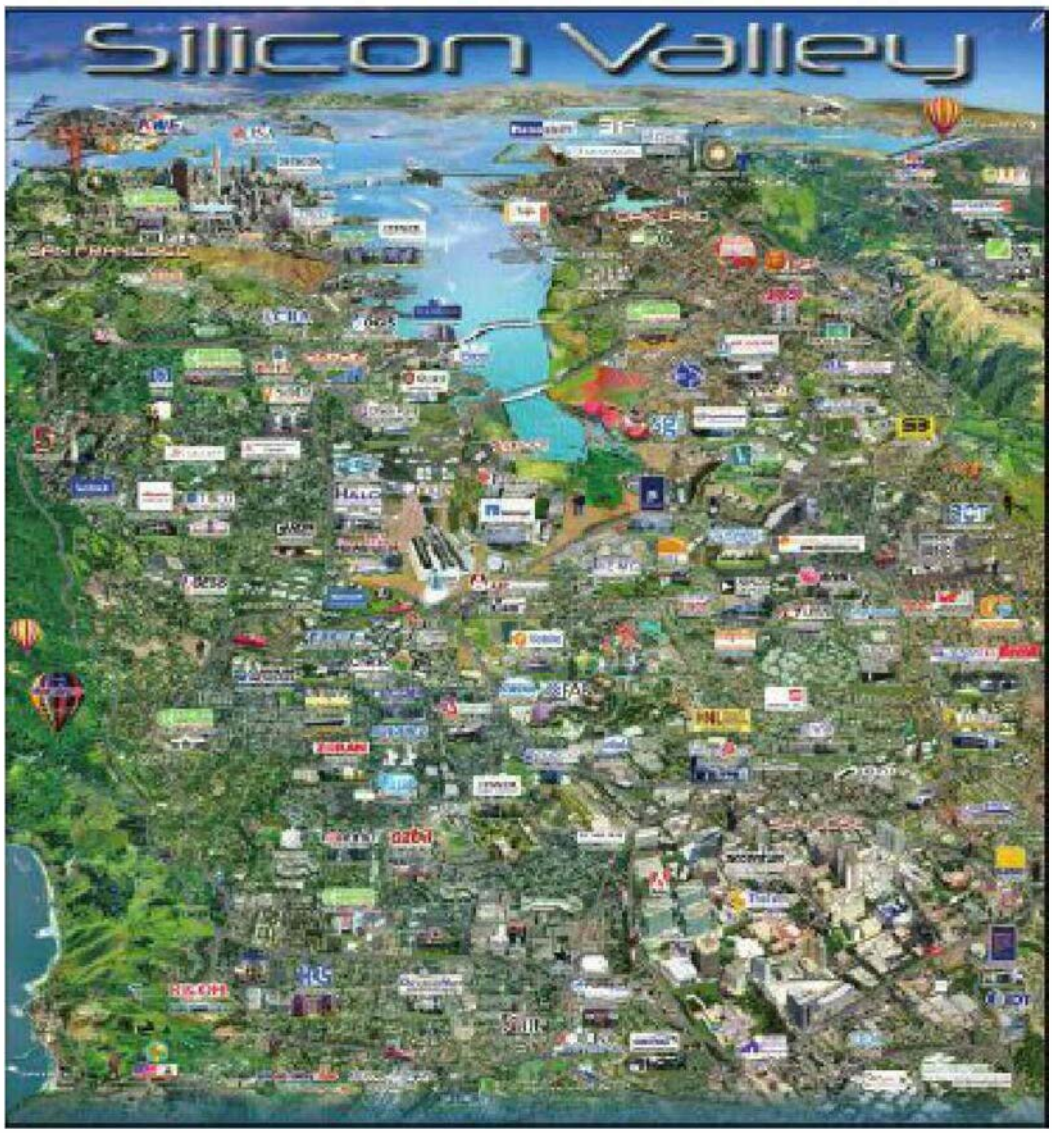
Vernon's theory has merit. Firms do invest in a foreign country when demand in that country will support local production, and they do invest in low-cost locations (e.g., developing countries) when cost pressures become intense.[22] However, Vernon's theory fails to explain why it is profitable for a firm to undertake FDI at such times, rather than continuing to export from its home base or licensing a foreign firm to produce its product. Just because demand in a foreign country is large enough to support local production, it does not necessarily follow that local production is the most profitable option. It may still be more profitable to produce at home and export to that country (to realize the economies of scale that arise from serving the global market from one location). Alternatively, it may be more profitable for the firm to license a foreign company to produce its product for sale in that country. The product life-cycle theory ignores these options and, instead, simply argues that once a foreign market is large enough to support local production, FDI will occur. This limits its explanatory power and its usefulness to business in that it fails to identify when it is profitable to invest abroad.

THE ECLECTIC PARADIGM

The eclectic paradigm has been championed by the British economist John Dunning.[23] Dunning argues that in addition to the various factors discussed above, location-specific advantages are also of considerable importance in explaining both the rationale for and the direction of foreign direct investment. By **location-specific advantages**, Dunning means the advantages that arise from utilizing resource endowments or assets that are tied to a particular foreign location and that a firm finds valuable to combine with its own unique assets (such as the firm's technological, marketing, or management capabilities). Dunning accepts the argument of internalization theory that it is difficult for a firm to license its own unique capabilities and know-how. Therefore, he argues that combining location-specific assets or resource endowments with the firm's own unique capabilities often requires foreign direct investment. That is, it requires the firm to establish production facilities where those foreign assets or resource endowments are located.

An obvious example of Dunning's arguments are natural resources, such as oil and other minerals, which are by their character specific to certain locations. Dunning suggests that to exploit such foreign resources, a firm must undertake FDI. Clearly, this explains the FDI undertaken by many of the world's oil companies, which have to invest where oil is located in order to combine their technological and managerial capabilities with this valuable location-specific resource. Another obvious example is valuable human resources, such as low-cost, highly skilled labor. The cost and skill of labor varies from country to country. Since labor is not internationally mobile, according to Dunning it makes sense for a firm to locate production facilities in those countries where the cost and skills of local labor are most suited to its particular production processes.

However, Dunning's theory has implications that go beyond basic resources such as minerals and labor. Consider Silicon Valley, which is the world center for the computer and semiconductor industry. Many of the world's major computer and semiconductor companies, such as Apple Computer, Hewlett-Packard, and Intel, are located close to each other in the Silicon Valley region of California. As a result, much of the cutting-edge research and product development in computers and semiconductors occurs there. According to Dunning's arguments, knowledge being generated in Silicon Valley with regard to the design and manufacture of computers and semiconductors is available nowhere else in the world. To be sure, as it is commercialized that knowledge diffuses throughout the world, but the leading edge of knowledge generation in the computer and semiconductor industries is to be found in Silicon Valley. In Dunning's language, this means that Silicon Valley has a *location-specific advantage* in the generation of knowledge related to the computer



Silicon Valley has long been known as the epicenter of the computer and semiconductor industry.

and semiconductor industries. In part, this advantage comes from the sheer concentration of intellectual talent in this area, and in part it arises from a network of informal contacts that allows firms to benefit from each others' knowledge generation. Economists refer to such knowledge "spillovers" as **externalities**, and there is a well-established theory suggesting that firms can benefit from such externalities by locating close to their source.[24]

Insofar as this is the case, it makes sense for foreign computer and semiconductor firms to invest in research and, perhaps, production facilities so they too can learn about and utilize valuable new knowledge before those based elsewhere, thereby giving them a competitive advantage in the global marketplace.[25] Evidence suggests that European, Japanese, South Korean, and Taiwanese computer and semiconductor firms are investing in the Silicon Valley region, precisely because they wish to benefit from the externalities that arise there.[26] Others have argued that direct investment by foreign firms in the U.S. biotechnology industry has been motivated by desires to gain access to the unique location-specific technological knowledge of U.S. biotechnology firms.[27] Dunning's theory, therefore, seems to be a useful addition to those outlined above, for it helps explain how location factors affect the direction of FDI.[28]

Political Ideology and Foreign Direct Investment

LO3

Historically, political ideology toward FDI within a nation has ranged from a dogmatic radical stance that is hostile to all inward FDI at one extreme to an adherence to the noninterventionist principle of free market economics at the other. Between these two extremes is an approach that might be called *pragmatic nationalism*.

THE RADICAL VIEW

The radical view traces its roots to Marxist political and economic theory. Radical writers argue that the multinational enterprise (MNE) is an instrument of imperialist domination. They see the MNE as a tool for exploiting host countries to the exclusive benefit of their capitalist-imperialist home countries. They argue that MNEs extract profits from the host country and take them to their home country, giving nothing of value to the host country in exchange. They note, for example, that key technology is tightly controlled by the MNE, and that important jobs in the foreign subsidiaries of MNEs go to home-country nationals rather than to citizens of the host country. Because of this, according to the radical view, FDI by the MNEs of advanced capitalist nations keeps the less developed countries of the world relatively backward and dependent on advanced capitalist nations for investment, jobs, and technology. Thus, according to the extreme version of this view, no country should ever permit foreign corporations to undertake FDI, since they can never be instruments of economic development, only of economic domination. Where MNEs already exist in a country, they should be immediately nationalized.[29]

From 1945 until the 1980s, the radical view was very influential in the world economy. Until the collapse of communism between 1989 and 1991, the countries of Eastern Europe were opposed to FDI. Similarly, communist countries elsewhere, such as China, Cambodia, and Cuba, were all opposed in principle to FDI (although in practice the Chinese started to allow FDI in mainland China in the 1970s). Many socialist countries, particularly in Africa where one of the first actions of many newly independent states was to nationalize foreign-owned enterprises, also embraced the radical position. Countries whose political ideology was more nationalistic than socialistic further embraced the radical position. This was true in Iran and India, for example, both of which adopted tough policies restricting FDI and nationalized many foreign-owned enterprises. Iran is a particularly interesting case because its Islamic government, while rejecting Marxist theory, has essentially embraced the radical view that FDI by MNEs is an instrument of imperialism.

By the end of the 1980s, the radical position was in retreat almost everywhere. There seem to be three reasons for this: (1) the collapse of communism in Eastern Europe; (2) the generally abysmal economic performance of those countries that embraced the radical position, and a growing belief by many of these countries that FDI can be an important source of technology and jobs and can stimulate economic growth; and (3) the strong economic performance of those developing countries that embraced capitalism rather than radical ideology (e.g., Singapore, Hong Kong, and Taiwan).

THE FREE MARKET VIEW

The free market view traces its roots to classical economics and the international trade theories of Adam Smith and David Ricardo (see Chapter 6). The intellectual case for this view has been strengthened by the internalization explanation of FDI. The free market view argues that international production should be distributed among countries according to the theory of comparative advantage. Countries should specialize in the production of those goods and services that they can produce most efficiently. Within this framework, the MNE is an instrument for dispersing the production of goods and

services to the most efficient locations around the globe. Viewed this way, FDI by the MNE increases the overall efficiency of the world economy.

Imagine that Dell decided to move assembly operations for many of its personal computers from the United States to Mexico to take advantage of lower labor costs in Mexico. According to the free market view, moves such as this can be seen as increasing the overall efficiency of resource utilization in the world economy. Mexico, due to its lower labor costs, has a comparative advantage in the assembly of PCs. By moving the production of PCs from the United States to Mexico, Dell frees U.S. resources for use in activities in which the United States has a comparative advantage (e.g., the design of computer software, the manufacture of high value-added components such as microprocessors, or basic R&D). Also, consumers benefit because the PCs cost less than they would if they were produced domestically. In addition, Mexico gains from the technology, skills, and capital that the computer company transfers with its FDI. Contrary to the radical view, the free market view stresses that such resource transfers benefit the host country and stimulate its economic growth. Thus, the free market view argues that FDI is a benefit to both the source country and the host country.

For reasons explored earlier in this book (see Chapter 2), the free market view has been ascendant worldwide in recent years, spurring a global move toward the removal of restrictions on inward and outward foreign direct investment. However, in practice no country has adopted the free market view in its pure form (just as no country has adopted the radical view in its pure form). Countries such as Great Britain and the United States are among the most open to FDI, but the governments of these countries both have still reserved the right to intervene. Britain does so by reserving the right to block foreign takeovers of domestic firms if the takeovers are seen as "contrary to national security interests" or if they have the potential for "reducing competition." (In practice, the UK government has rarely exercised this right.) U.S. controls on FDI are more limited and largely informal. For political reasons, the United States will occasionally restrict U.S. firms from undertaking FDI in certain countries (e.g., Cuba and Iran). In addition, inward FDI meets some limited restrictions. For example, foreigners are prohibited from purchasing more than 25 percent of any U.S. airline or from acquiring a controlling interest in a U.S. television broadcast network. Since 1988, the government has had the right to review the acquisition of a U.S. enterprise by a foreign firm on the grounds of national security. However, of the 1,500 bids reviewed by the Committee on Foreign Investment in the United States under this law by 2008, only one has been nullified: the sale of a Seattle-based aircraft parts manufacturer to a Chinese enterprise in the early 1990s.[30]

PRAGMATIC NATIONALISM

In practice, many countries have adopted neither a radical policy nor a free market policy toward FDI, but instead a policy that can best be described as pragmatic nationalism.[31] The pragmatic nationalist view is that FDI has both benefits and costs. FDI can benefit a host country by bringing capital, skills, technology, and jobs, but those benefits come at a cost. When a foreign company rather than a domestic company produces products, the profits from that investment go abroad. Many countries are also concerned that a foreign-owned manufacturing plant may import many components from its home country, which has negative implications for the host country's balance-of-payments position.

Recognizing this, countries adopting a pragmatic stance pursue policies designed to maximize the national benefits and minimize the national costs. According to this view, FDI should be allowed so long as the benefits outweigh the costs. Japan offers an example of pragmatic nationalism. Until the 1980s, Japan's policy was probably one of the most restrictive among countries adopting a pragmatic nationalist stance. This was due to Japan's perception that direct entry of foreign (especially U.S.) firms with ample managerial resources into the Japanese markets could hamper the development and growth of their own industry and technology.[32] This belief led Japan to block the majority of applications to invest in Japan. However, there were always exceptions to this policy. Firms

that had important technology were often permitted to undertake FDI if they insisted that they would neither license their technology to a Japanese firm nor enter into a joint venture with a Japanese enterprise. IBM and Texas Instruments were able to set up wholly owned subsidiaries in Japan by adopting this negotiating position. From the perspective of the Japanese government, the benefits of FDI in such cases—the stimulus that these firms might impart to the Japanese economy—outweighed the perceived costs.

Another aspect of pragmatic nationalism is the tendency to aggressively court FDI believed to be in the national interest by, for example, offering subsidies to foreign MNEs in the form of tax breaks or grants. The countries of the European Union often seem to be competing with each other to attract U.S. and Japanese FDI by offering large tax breaks and subsidies. Britain has been the most successful at attracting Japanese investment in the automobile industry. Nissan, Toyota, and Honda now have major assembly plants in Britain and use the country as their base for serving the rest of Europe—with obvious employment and balance-of-payments benefits for Britain.

SHIFTING IDEOLOGY

Recent years have seen a marked decline in the number of countries that adhere to a radical ideology. Although few countries have adopted a pure free market policy stance, an increasing number of countries are gravitating toward the free market end of the spectrum and have liberalized their foreign investment regime. This includes many countries that less than two decades ago were firmly in the radical camp (e.g., the former communist countries of Eastern Europe and many of the socialist countries of Africa) and several countries that until recently could best be described as pragmatic nationalists with regard to FDI (e.g., Japan, South Korea, Italy, Spain, and most Latin American countries). One result has been the surge in the volume of FDI worldwide, which, as we noted earlier, has been growing twice as fast as the growth in world trade. Another result has been an increase in the volume of FDI directed at countries that have recently liberalized their FDI regimes, such as China, India, and Vietnam.

As a counterpoint, there is evidence of the beginnings of what might become a shift to a more hostile approach to foreign direct investment. Venezuela and Bolivia have become increasingly hostile to foreign direct investment. In 2005 and 2006, the governments of both nations unilaterally rewrote contracts for oil and gas exploration, raising the royalty rate that foreign enterprises had to pay the government for oil and gas extracted in their territories. Following his election victory in 2006, Bolivian President Evo Morales nationalized the nation's gas fields and stated that he would evict foreign firms unless they agreed to pay about 80 percent of their revenues to the state and relinquish production oversight. In some developed nations too, there is increasing evidence of hostile reactions to inward FDI. In Europe in 2006, there was a hostile political reaction to the attempted takeover of Europe's largest steel company, Arcelor, by Mittal Steel, a global company controlled by the Indian entrepreneur Lakshmi Mittal. In mid-2005 China National Offshore Oil Company withdrew a takeover bid for Unocal of the United States after highly negative reaction in Congress about the proposed takeover of a "strategic asset" by a Chinese company. Similarly, as detailed in the accompanying Management Focus, in 2006 a Dubai-owned company withdrew its planned takeover of some operations at six U.S. ports after negative political reactions. So far, these countertrends are nothing more than isolated incidents, but if they become more widespread, the 30-year movement toward lower barriers to cross-border investment could be in jeopardy.

Benefits and Costs of FDI

LO4

To a greater or lesser degree, many governments can be considered pragmatic nationalists when it comes to FDI. Accordingly, their policy is shaped by a consideration of the costs and benefits of FDI. Here we explore the benefits and costs of FDI, first from the perspective of a host (receiving) country, and then from the perspective of the home



MANAGEMENT FOCUS

DP World and the United States

In February 2006, DP World, a ports operator with global reach owned by the government of Dubai, a member of the United Arab Emirates and a staunch U.S. ally, paid $6.8 billion to acquire P&O, a British firm that runs a global network of marine terminals. With P&O came the management operations of six U.S. ports: Miami, Philadelphia, Baltimore, New Orleans, New Jersey, and New York. The acquisition had already been approved by U.S. regulators when it suddenly became front-page news. Upon hearing about the deal, several prominent U.S. senators raised concerns about the acquisition. Their objections were twofold. First, they raised questions about the security risks associated with management operations in key U.S. ports being owned by a foreign enterprise that was based in the Middle East. The implication was that terrorists could somehow take advantage of the ownership arrangement to infiltrate U.S. ports. Second, they were concerned that DP World was a state-owned enterprise and argued that foreign governments should not be in a position of owning key "U.S. strategic assets."

The Bush administration was quick to defend the takeover, stating it posed no threat to national security. Others noted that DP World was a respected global firm with an American chief operating officer and an American-educated chairman; the head of the global ports management operation would also be an American. DP World would not own the U.S. ports in question, just manage them, while security issues would remain in the hands of American customs officials and the U.S. Coast Guard. Dubai was also a member of America's Container Security Initiative, which allows American customs officials to inspect cargo in foreign ports before it leaves for the United States. Most of the DP World employees at American ports would be U.S. citizens, and any UAE citizen transferred to DP World would be subject to American visa approval.

These arguments fell on deaf ears. With several U.S. senators threatening to pass legislation to prohibit foreign ownership of U.S. port operations, DP World bowed to the inevitable and announced it would sell off the right to mange the six U.S. ports for about $750 million. Looking forward, however, DP World stated it would seek an initial public offering in 2007, and the then-private firm would in all probability continue to look for ways to enter the United States. In the words of the firm's CEO, "This is the world's largest economy. How can you just ignore it?"[33]

(source) country. In the next section, we look at the policy instruments governments use to manage FDI.

HOST-COUNTRY BENEFITS

The main benefits of inward FDI for a host country arise from resource-transfer effects, employment effects, balance-of-payments effects, and effects on competition and economic growth.

Resource-Transfer Effects

Foreign direct investment can make a positive contribution to a host economy by supplying capital, technology, and management resources that would otherwise not be available and thus boost that country's economic growth rate (as the opening case makes clear, the Japanese government has recently come around to this view and as adopted a more permissive attitude to inward investment).[34]

With regard to capital, many MNEs, by virtue of their large size and financial strength, have access to financial resources not available to host-country firms. These funds may be available from internal company sources, or, because of their reputation, large MNEs may find it easier to borrow money from capital markets than host-country firms would.

As for technology, you will recall from Chapter 2 that technology can stimulate economic development and industrialization. Technology can take two forms, both of which

are valuable. Technology can be incorporated in a production process (e.g., the technology for discovering, extracting, and refining oil) or it can be incorporated in a product (e.g., personal computers). However, many countries lack the research and development resources and skills required to develop their own indigenous product and process technology. This is particularly true in less developed nations. Such countries must rely on advanced industrialized nations for much of the technology required to stimulate economic growth, and FDI can provide it.

Research supports the view that multinational firms often transfer significant technology when they invest in a foreign country.[35] For example, a study of FDI in Sweden found that foreign firms increased both the labor and total factor productivity of Swedish firms that they acquired, suggesting that significant technology transfers had occurred (technology typically boosts productivity).[36] Also, a study of FDI by the Organization for Economic Cooperation and Development (OECD) found that foreign investors invested significant amounts of capital in R&D in the countries in which they had invested, suggesting that not only were they transferring technology to those countries, but they may also have been upgrading existing technology or creating new technology in those countries.[37]

Foreign management skills acquired through FDI may also produce important benefits for the host country. Foreign managers trained in the latest management techniques can often help to improve the efficiency of operations in the host country, whether those operations are acquired or greenfield developments. Beneficial spin-off effects may also arise when local personnel who are trained to occupy managerial, financial, and technical posts in the subsidiary of a foreign MNE leave the firm and help to establish indigenous firms. Similar benefits may arise if the superior management skills of a foreign MNE stimulate local suppliers, distributors, and competitors to improve their own management skills.

Employment Effects

Another beneficial employment effect claimed for FDI is that it brings jobs to a host country that would otherwise not be created there. The effects of FDI on employment are both direct and indirect. Direct effects arise when a foreign MNE employs a number of host-country citizens. Indirect effects arise when jobs are created in local suppliers as a result of the investment and when jobs are created because of increased local spending by employees of the MNE. The indirect employment effects are often as large as, if not larger than, the direct effects. For example, when Toyota decided to open a new auto plant in France, estimates suggested the plant would create 2,000 direct jobs and perhaps another 2,000 jobs in support industries.[38]

Cynics argue that not all the "new jobs" created by FDI represent net additions in employment. In the case of FDI by Japanese auto companies in the United States, some argue that the jobs created by this investment have been more than offset by the jobs lost in U.S.-owned auto companies, which have lost market share to their Japanese competitors. As a consequence of such substitution effects, the net number of new jobs created by FDI may not be as great as initially claimed by an MNE. The issue of the likely net gain in employment may be a major negotiating point between an MNE wishing to undertake FDI and the host government.

When FDI takes the form of an acquisition of an established enterprise in the host economy as opposed to a greenfield investment, the immediate effect may be to reduce employment as the multinational tries to restructure the operations of the acquired unit to improve its operating efficiency. However, even in such cases, research suggests that once the initial period of restructuring is over, enterprises acquired by foreign



Job creation is a result of FDI. These French workers assemble cars at Toyota's Valenciennes manufacturing plant.

firms tend to grow their employment base at a faster rate than domestic rivals. For example, an OECD study found that foreign firms created new jobs at a faster rate than their domestic counterparts.[39] In America, the workforce of foreign firms grew by 1.4 percent per year, compared with 0.8 percent per year for domestic firms. In Britain and France, the workforce of foreign firms grew at 1.7 percent per year, while employment at domestic firms fell by 2.7 percent. The same study found that foreign firms tended to pay higher wage rates than domestic firms, suggesting that the quality of employment was better. Another study looking at FDI in Eastern European transition economies found that although employment fell following the acquisition of an enterprise by a foreign firm, often those enterprises were in competitive difficulties and would not have survived if they had not been acquired. Also, after an initial period of adjustment and retrenchment, employment downsizing was often followed by new investments, and employment either remained stable or increased.[40]

Balance-of-Payments Effects

FDI's effect on a country's balance-of-payments accounts is an important policy issue for most host governments. A country's **balance-of-payments accounts** track both its payments to and its receipts from other countries. Governments normally are concerned when their country is running a deficit on the current account of their balance of payments. The **current account** tracks the export and import of goods and services. A current account deficit, or trade deficit as it is often called, arises when a country is importing more goods and services than it is exporting. Governments typically prefer to see a current account surplus than a deficit. The only way in which a current account deficit can be supported in the long run is by selling off assets to foreigners (for a detailed explanation of why this is the case, see the Appendix to Chapter 6). For example, the persistent U.S. current account deficit since the 1980s has been financed by a steady sale of U.S. assets (stocks, bonds, real estate, and whole corporations) to foreigners. Since national governments invariably dislike seeing the assets of their country fall into foreign hands, they prefer their nation to run a current account surplus. There are two ways in which FDI can help a country to achieve this goal.

First, if the FDI is a substitute for imports of goods or services, the effect can be to improve the current account of the host country's balance of payments. Much of the FDI by Japanese automobile companies in the United States and Europe, for example, can be seen as substituting for imports from Japan. Thus, the current account of the U.S. balance of payments has improved somewhat because many Japanese companies are now supplying the U.S. market from production facilities in the United States, as opposed to facilities in Japan. Insofar as this has reduced the need to finance a current account deficit by asset sales to foreigners, the United States has clearly benefited.

A second potential benefit arises when the MNE uses a foreign subsidiary to export goods and services to other countries. According to a UN report, inward FDI by foreign multinationals has been a major driver of export-led economic growth in a number of developing and developed nations.[41] For example, in China exports increased from $26 billion in 1985 to more than $250 billion by 2001 and $969 billion in 2006. Much of this dramatic export growth was due to the presence of foreign multinationals that invested heavily in China during the 1990s. The subsidiaries of foreign multinationals accounted for 50 percent of all exports from that country in 2001, up from 17 percent in 1991. In mobile phones, for example, the Chinese subsidiaries of foreign multinationals—primarily Nokia, Motorola, Ericsson, and Siemens—accounted for 95 percent of China's exports.

Effect on Competition and Economic Growth

Economic theory tells us that the efficient functioning of markets depends on an adequate level of competition between producers. When FDI takes the form of a greenfield investment, the result is to establish a new enterprise, increasing the number of players in a market and thus consumer choice. In turn, this can increase the level of competition in a national market, thereby driving down prices and increasing the economic welfare

of consumers. Increased competition tends to stimulate capital investments by firms in plant, equipment, and R&D as they struggle to gain an edge over their rivals. The long-term results may include increased productivity growth, product and process innovations, and greater economic growth.[42] Such beneficial effects seem to have occurred in the South Korean retail sector following the liberalization of FDI regulations in 1996. FDI by large Western discount stores, including Walmart, Costco, Carrefour, and Tesco, seems to have encouraged indigenous discounters such as E-Mart to improve the efficiency of their own operations. The results have included more competition and lower prices, which benefit South Korean consumers.

FDI's impact on competition in domestic markets may be particularly important in the case of services, such as telecommunications, retailing, and many financial services, where exporting is often not an option because the service has to be produced where it is delivered.[43] For example, under a 1997 agreement sponsored by the World Trade Organization, 68 countries accounting for more than 90 percent of world telecommunications revenues pledged to start opening their markets to foreign investment and competition and to abide by common rules for fair competition in telecommunications. Before this agreement, most of the world's telecommunications markets were closed to foreign competitors, and in most countries the market was monopolized by a single carrier, which was often a state-owned enterprise. The agreement has dramatically increased the level of competition in many national telecommunications markets, producing two major benefits. First, inward investment has increased competition and stimulated investment in the modernization of telephone networks around the world, leading to better service. Second, the increased competition has resulted in lower prices.

HOST-COUNTRY COSTS

Three costs of FDI concern host countries. They arise from possible adverse effects on competition within the host nation, adverse effects on the balance of payments, and the perceived loss of national sovereignty and autonomy.

Adverse Effects on Competition

Host governments sometimes worry that the subsidiaries of foreign MNEs may have greater economic power than indigenous competitors. If it is part of a larger international organization, the foreign MNE may be able to draw on funds generated elsewhere to subsidize its costs in the host market, which could drive indigenous companies out of business and allow the firm to monopolize the market. Once the market is monopolized, the foreign MNE could raise prices above those that would prevail in competitive markets, with harmful effects on the economic welfare of the host nation. This concern tends to be greater in countries that have few large firms of their own (generally less developed countries). It tends to be a relatively minor concern in most advanced industrialized nations.

In general, while FDI in the form of greenfield investments should increase competition, it is less clear that this is the case when the FDI takes the form of acquisition of an established enterprise in the host nation, as was the case when Cemex acquired RMC in Britain (see the Management Focus). Because an acquisition does not result in a net increase in the number of players in a market, the effect on competition may be neutral. When a foreign investor acquires two or more firms in a host country, and subsequently merges them, the effect may be to reduce the level of competition in that market, create monopoly power for the foreign firm, reduce consumer choice, and raise prices. For example, in India, Hindustan Lever Ltd., the Indian subsidiary of Unilever, acquired its main local rival, Tata Oil Mills, to assume a dominant position in the bath soap (75 percent) and detergents (30 percent) markets. Hindustan Lever also acquired several local companies in other markets, such as the ice cream makers Dollops, Kwality, and Milkfood. By combining these companies, Hindustan Lever's share of the Indian ice cream market went from zero in 1992 to 74 percent in 1997.[44] However, although such cases are of obvious concern, there is little evidence that such developments are widespread.

In many nations, domestic competition authorities have the right to review and block any mergers or acquisitions that they view as having a detrimental impact on competition. If such institutions are operating effectively, this should be sufficient to make sure that foreign entities do not monopolize a country's markets.

Adverse Effects on the Balance of Payments

The possible adverse effects of FDI on a host country's balance-of-payments position are twofold. First, set against the initial capital inflow that comes with FDI must be the subsequent outflow of earnings from the foreign subsidiary to its parent company. Such outflows show up as capital outflow on balance-of-payments accounts. Some governments have responded to such outflows by restricting the amount of earnings that can be repatriated to a foreign subsidiary's home country. A second concern arises when a foreign subsidiary imports a substantial number of its inputs from abroad, which results in a debit on the current account of the host country's balance of payments. One criticism leveled against Japanese-owned auto assembly operations in the United States, for example, is that they tend to import many component parts from Japan. Because of this, the favorable impact of this FDI on the current account of the U.S. balance-of-payments position may not be as great as initially supposed. The Japanese auto companies responded to these criticisms by pledging to purchase 75 percent of their component parts from U.S.-based manufacturers (but not necessarily U.S.-owned manufacturers). When the Japanese auto company Nissan invested in the United Kingdom, Nissan responded to concerns about local content by pledging to increase the proportion of local content to 60 percent and subsequently raising it to more than 80 percent.

National Sovereignty and Autonomy

Some host governments worry that FDI is accompanied by some loss of economic independence. The concern is that key decisions that can affect the host country's economy will be made by a foreign parent that has no real commitment to the host country, and over which the host country's government has no real control. Most economists dismiss such concerns as groundless and irrational. Political scientist Robert Reich has noted that such concerns are the product of outmoded thinking because they fail to account for the growing interdependence of the world economy.[45] In a world in which firms from all advanced nations are increasingly investing in each other's markets, it is not possible for one country to hold another to "economic ransom" without hurting itself.

HOME-COUNTRY BENEFITS

The benefits of FDI to the home (source) country arise from three sources. First, the home country's balance of payments benefits from the inward flow of foreign earnings. FDI can also benefit the home country's balance of payments if the foreign subsidiary creates demands for home-country exports of capital equipment, intermediate goods, complementary products, and the like.

Second, benefits to the home country from outward FDI arise from employment effects. As with the balance of payments, positive employment effects arise when the foreign subsidiary creates demand for home-country exports. Thus, Toyota's investment in auto assembly operations in Europe has benefited both the Japanese balance-of-payments position and employment in Japan, because Toyota imports some component parts for its European-based auto assembly operations directly from Japan.

Third, benefits arise when the home-country MNE learns valuable skills from its exposure to foreign markets that can subsequently be transferred back to the home country. This amounts to a reverse resource-transfer effect. Through its exposure to a foreign market, an MNE can learn about superior management techniques and superior product and process technologies. These resources can then be transferred back to the home country, contributing to the home country's economic growth rate.[46] For example, one reason General Motors and Ford invested in Japanese automobile companies (GM owns part of Isuzu, and Ford owns part of Mazda) was to learn about their production processes.

If GM and Ford are successful in transferring this know-how back to their U.S. operations, the result may be a net gain for the U.S. economy.

HOME-COUNTRY COSTS

Against these benefits must be set the apparent costs of FDI for the home (source) country. The most important concerns center on the balance-of-payments and employment effects of outward FDI. The home country's balance of payments may suffer in three ways. First, the balance of payments suffers from the initial capital outflow required to finance the FDI. This effect, however, is usually more than offset by the subsequent inflow of foreign earnings. Second, the current account of the balance of payments suffers if the purpose of the foreign investment is to serve the home market from a low-cost production location. Third, the current account of the balance of payments suffers if the FDI is a substitute for direct exports. Thus, insofar as Toyota's assembly operations in the United States are intended to substitute for direct exports from Japan, the current account position of Japan will deteriorate.

With regard to employment effects, the most serious concerns arise when FDI is seen as a substitute for domestic production. This was the case with Toyota's investments in the United States and Europe. One obvious result of such FDI is reduced home-country employment. If the labor market in the home country is already tight, with little unemployment, this concern may not be that great. However, if the home country is suffering from unemployment, concern about the export of jobs may arise. For example, one objection frequently raised by U.S. labor leaders to the free trade pact between the United States, Mexico, and Canada (see the next chapter) is that the United States will lose hundreds of thousands of jobs as U.S. firms invest in Mexico to take advantage of cheaper labor and then export back to the United States.[47]

INTERNATIONAL TRADE THEORY AND FDI

When assessing the costs and benefits of FDI to the home country, keep in mind the lessons of international trade theory (see Chapter 6). International trade theory tells us that home-country concerns about the negative economic effects of offshore production may be misplaced. The term **offshore production** refers to FDI undertaken to serve the home market. Far from reducing home-country employment, such FDI may actually stimulate economic growth (and hence employment) in the home country by freeing home-country resources to concentrate on activities where the home country has a comparative advantage. In addition, home-country consumers benefit if the price of the particular product falls as a result of the FDI. Also, if a company were prohibited from making such investments on the grounds of negative employment effects while its international competitors reaped the benefits of low-cost production locations, it would undoubtedly lose market share to its international competitors. Under such a scenario, the adverse long-run economic effects for a country would probably outweigh the relatively minor balance-of-payments and employment effects associated with offshore production.

Government Policy Instruments and FDI LO5

We have now reviewed the costs and benefits of FDI from the perspective of both home country and host country. We now turn our attention to the policy instruments that home (source) countries and host countries can use to regulate FDI.

HOME-COUNTRY POLICIES

Through their choice of policies, home countries can both encourage and restrict FDI by local firms. We look at policies designed to encourage outward FDI first. These include foreign risk insurance, capital assistance, tax incentives, and political pressure. Then we will look at policies designed to restrict outward FDI.

Encouraging Outward FDI

Many investor nations now have government-backed insurance programs to cover major types of foreign investment risk. The types of risks insurable through these programs include the risks of expropriation (nationalization), war losses, and the inability to transfer profits back home. Such programs are particularly useful in encouraging firms to undertake investments in politically unstable countries.[48] In addition, several advanced countries also have special funds or banks that make government loans to firms wishing to invest in developing countries. As a further incentive to encourage domestic firms to undertake FDI, many countries have eliminated double taxation of foreign income (i.e., taxation of income in both the host country and the home country). Last, and perhaps most significant, a number of investor countries (including the United States) have used their political influence to persuade host countries to relax their restrictions on inbound FDI. For example, in response to direct U.S. pressure, Japan relaxed many of its formal restrictions on inward FDI in the 1980s. Now, in response to further U.S. pressure, Japan has moved toward relaxing its informal barriers to inward FDI. One beneficiary of this trend has been Toys "R" Us, which, after five years of intensive lobbying by company and U.S. government officials, opened its first retail stores in Japan in December 1991. By 2009, Toys "R" Us had more 170 stores in Japan, and its Japanese operation, in which Toys "R" Us retained a controlling stake, had a listing on the Japanese stock market.

Restricting Outward FDI

Virtually all investor countries, including the United States, have exercised some control over outward FDI from time to time. One policy has been to limit capital outflows out of concern for the country's balance of payments. From the early 1960s until 1979, for example, Britain had exchange-control regulations that limited the amount of capital a firm could take out of the country. Although the main intent of such policies was to improve the British balance of payments, an important secondary intent was to make it more difficult for British firms to undertake FDI.

In addition, countries have occasionally manipulated tax rules to try to encourage their firms to invest at home. The objective behind such policies is to create jobs at home rather than in other nations. At one time, Britain adopted such policies. The British advanced corporation tax system taxed British companies' foreign earnings at a higher rate than their domestic earnings. This tax code created an incentive for British companies to invest at home.

Finally, countries sometimes prohibit national firms from investing in certain countries for political reasons. Such restrictions can be formal or informal. For example, formal U.S. rules prohibited U.S. firms from investing in countries such as Cuba and Iran, whose political ideology and actions are judged to be contrary to U.S. interests. Similarly, during the 1980s, informal pressure was applied to dissuade U.S. firms from investing in South Africa. In this case, the objective was to pressure South Africa to change its apartheid laws, which happened during the early 1990s.



Because Japan was willing to relax some obstacles to FDI, Toys "R" Us was able to open stores there.

HOST-COUNTRY POLICIES

Host countries adopt policies designed both to restrict and to encourage inward FDI. As noted earlier in this chapter, political ideology has determined the type and scope of these policies in the past. In the last decade of the twentieth century, many countries moved quickly away from adhering to some version of the radical stance and prohibiting much FDI, and toward a situation where a combination of free market objectives and pragmatic nationalism took hold.

Encouraging Inward FDI

It is common for governments to offer incentives to foreign firms to invest in their countries. Such incentives take many forms, but the most common are tax concessions, low-interest loans, and grants or subsidies. Incentives are motivated by a desire to gain from the resource-transfer and employment effects of FDI. They are also motivated by a desire to capture FDI away from other potential host countries. For example, in the mid-1990s, the governments of Britain and France competed with each other on the incentives they offered Toyota to invest in their respective countries. In the United States, state governments often compete with each other to attract FDI. For example, Kentucky offered Toyota an incentive package worth $112 million to persuade it to build its U.S. automobile assembly plants there. The package included tax breaks, new state spending on infrastructure, and low-interest loans.[49]

Restricting Inward FDI

Host governments use a wide range of controls to restrict FDI in one way or another. The two most common are ownership restraints and performance requirements. Ownership restraints can take several forms. In some countries, foreign companies are excluded from specific fields. They are excluded from tobacco and mining in Sweden and from the development of certain natural resources in Brazil, Finland, and Morocco. In other industries, foreign ownership may be permitted although a significant proportion of the equity of the subsidiary must be owned by local investors. Foreign ownership is restricted to 25 percent or less of an airline in the United States. In India, foreign firms were prohibited from owning media businesses until 2001, when the rules were relaxed, allowing foreign firms to purchase up to 26 percent of a foreign newspaper.[50]

The rationale underlying ownership restraints seems to be twofold. First, foreign firms are often excluded from certain sectors on the grounds of national security or competition. Particularly in less developed countries, the feeling seems to be that local firms might not be able to develop unless foreign competition is restricted by a combination of import tariffs and controls on FDI. This is a variant of the infant industry argument discussed in Chapter 7.

Second, ownership restraints seem to be based on a belief that local owners can help to maximize the resource-transfer and employment benefits of FDI for the host country. Until the early 1980s, the Japanese government prohibited most FDI but allowed joint ventures between Japanese firms and foreign MNEs if the MNE had a valuable technology. The Japanese government clearly believed such an arrangement would speed up the subsequent diffusion of the MNE's valuable technology throughout the Japanese economy.

Performance requirements can also take several forms. Performance requirements are controls over the behavior of the MNE's local subsidiary. The most common performance requirements are related to local content, exports, technology transfer, and local participation in top management. As with certain ownership restrictions, the logic underlying performance requirements is that such rules help to maximize the benefits and minimize the costs of FDI for the host country. Many countries employ some form of performance requirements when it suits their objectives. However, performance requirements tend to be more common in less developed countries than in advanced industrialized nations.[51]

INTERNATIONAL INSTITUTIONS AND THE LIBERALIZATION OF FDI

Until the 1990s, there was no consistent involvement by multinational institutions in the governing of FDI. This changed with the formation of the World Trade Organization in 1995. The WTO embraces the promotion of international trade in services. Since many services have to be produced where they are sold, exporting is not an option (for example, one cannot export McDonald's hamburgers or consumer banking services). Given this, the WTO has become involved in regulations governing FDI. As might be expected for an institution created to promote free trade, the thrust of the WTO's efforts

has been to push for the liberalization of regulations governing FDI, particularly in services. Under the auspices of the WTO, two extensive multinational agreements were reached in 1997 to liberalize trade in telecommunications and financial services. Both these agreements contained detailed clauses that require signatories to liberalize their regulations governing inward FDI, essentially opening their markets to foreign telecommunications and financial services companies.

The WTO has had less success trying to initiate talks aimed at establishing a universal set of rules designed to promote the liberalization of FDI. Led by Malaysia and India, developing nations have so far rejected efforts by the WTO to start such discussions. In an attempt to make some progress on this issue, the OECD in 1995 initiated talks between its members. (The OECD is a Paris-based intergovernmental organization of "wealthy" nations whose purpose is to provide its 29 member states with a forum in which governments can compare their experiences, discuss the problems they share, and seek solutions that can then be applied within their own national contexts. The members include most EU countries, the United States, Canada, Japan, and South Korea.) The aim of the talks was to draft a multilateral agreement on investment (MAI) that would make it illegal for signatory states to discriminate against foreign investors. This would liberalize rules governing FDI between OECD states.

These talks broke down in early 1998, primarily because the United States refused to sign the agreement. According to the United States, the proposed agreement contained too many exceptions that would weaken its powers. For example, the proposed agreement would not have barred discriminatory taxation of foreign-owned companies, and it would have allowed countries to restrict foreign television programs and music in the name of preserving culture. Environmental and labor groups also campaigned against the MAI, criticizing the proposed agreement because it contained no binding environmental or labor agreements. Despite such setbacks, negotiations on a revised MAI treaty might restart in the future. Moreover, as noted earlier, many individual nations have continued to liberalize their policies governing FDI to encourage foreign firms to invest in their economies.[52]

IMPLICATIONS FOR MANAGERS

LO6

Several implications for business are inherent in the material discussed in this chapter. In this section, we deal first with the implications of the theory and then turn our attention to the implications of government policy.

THE THEORY OF FDI

The implications of the theories of FDI for business practice are straightforward. First, the location-specific advantages argument associated with John Dunning does help explain the *direction* of FDI. However, the location-specific advantages argument does not explain *why* firms prefer FDI to licensing or to exporting. In this regard, from both an explanatory and a business perspective perhaps the most useful theories are those that focus on the limitations of exporting and licensing, that is, internalization theories. These theories are useful because they identify with some precision how the relative profitability of foreign direct investment, exporting, and licensing vary with circumstances. The theories suggest that exporting is preferable to licensing and FDI so long as transportation costs are minor and trade barriers are trivial. As transportation costs or trade barriers increase, exporting becomes unprofitable, and the choice is between FDI and licensing. Since FDI is more costly and more risky than licensing, other things being equal, the theories argue that licensing is preferable to FDI. Other things are seldom equal, however. Although licensing may work, it is not an attractive option when one or more of the following

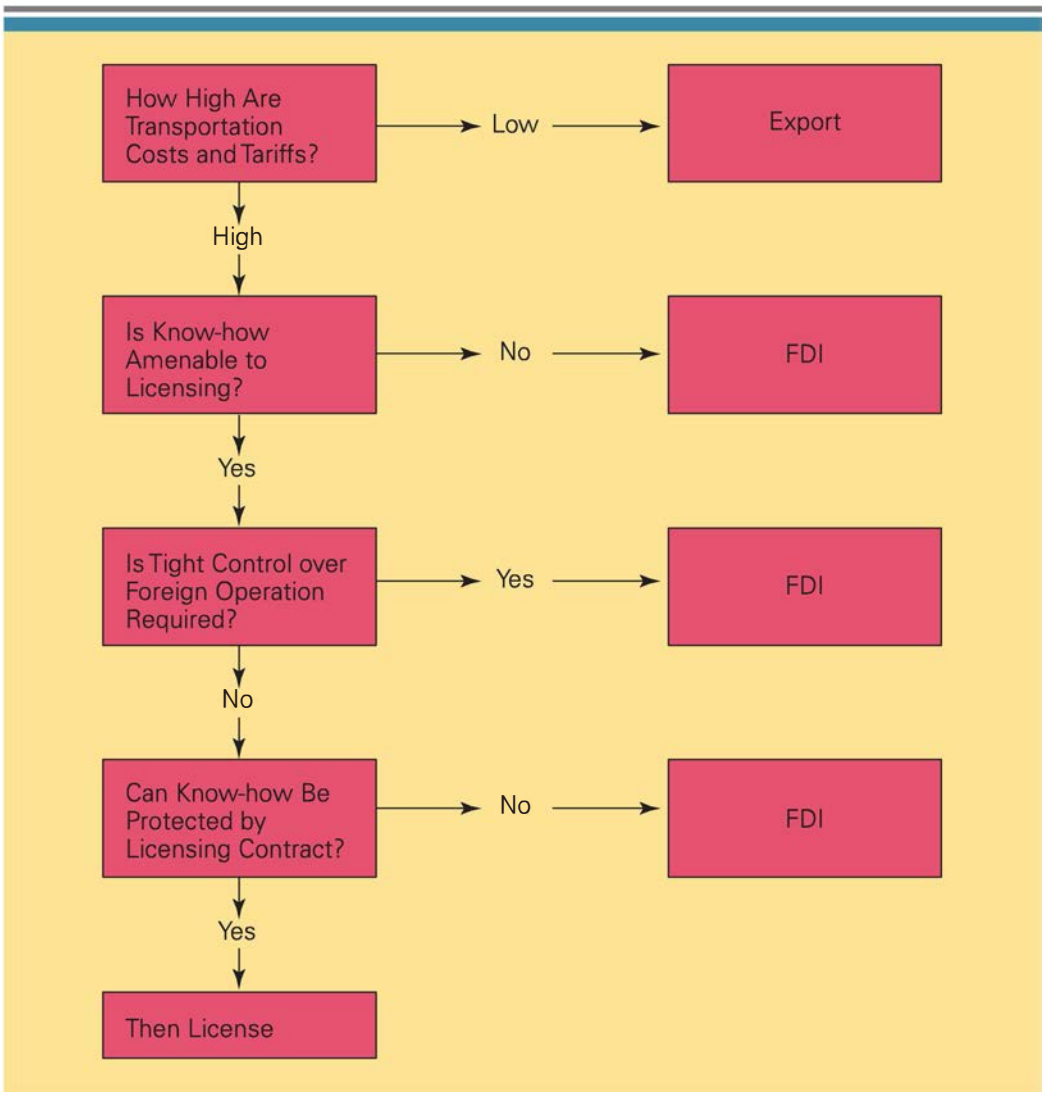


FIGURE 8.6
A Decision Framework

conditions exist: (*a*) the firm has valuable know-how that cannot be adequately protected by a licensing contract, (*b*) the firm needs tight control over a foreign entity to maximize its market share and earnings in that country, and (*c*) a firm's skills and capabilities are not amenable to licensing. Figure 8.6 presents these considerations as a decision tree.

Firms for which licensing is not a good option tend to be clustered in three types of industries:

1. High-technology industries in which protecting firm-specific expertise is of paramount importance and licensing is hazardous.
2. Global oligopolies, in which competitive interdependence requires that multinational firms maintain tight control over foreign operations so that they have the ability to launch coordinated attacks against their global competitors (as Kodak did with Fuji).
3. Industries in which intense cost pressures require that multinational firms maintain tight control over foreign operations (so that they can disperse manufacturing to locations around the globe where factor costs are most favorable in order to minimize costs).

Although empirical evidence is limited, the majority seems to support these conjectures.[53] In addition, licensing is not a good option if the competitive advantage of a firm is

based upon managerial or marketing knowledge that is embedded in the routines of the firm or the skills of its managers, and that is difficult to codify in a "book of blueprints." This would seem to be the case for firms based in a fairly wide range of industries.

Firms for which licensing is a good option tend to be in industries whose conditions are opposite to those specified above. That is, licensing tends to be more common, and more profitable, in fragmented, low-technology industries in which globally dispersed manufacturing is not an option. A good example is the fast-food industry. McDonald's has expanded globally by using a franchising strategy. Franchising is essentially the service-industry version of licensing, although it normally involves much longer-term commitments than licensing. With franchising, the firm licenses its brand name to a foreign firm in return for a percentage of the franchisee's profits. The franchising contract specifies the conditions that the franchisee must fulfill if it is to use the franchisor's brand name. Thus McDonald's allows foreign firms to use its brand name so long as they agree to run their restaurants on exactly the same lines as McDonald's restaurants elsewhere in the world. This strategy makes sense for McDonald's because (*a*) like many services, fast food cannot be exported, (*b*) franchising economizes the costs and risks associated with opening up foreign markets, (*c*) unlike technological know-how, brand names are relatively easy to protect using a contract, (*d*) there is no compelling reason for McDonald's to have tight control over franchisees, and (*e*) McDonald's know-how, in terms of how to run a fast-food restaurant, is amenable to being specified in a written contract (e.g., the contract specifies the details of how to run a McDonald's restaurant).

Finally, it should be noted that the product life-cycle theory and Knickerbocker's theory of FDI tend to be less useful from a business perspective. The problem with these two theories is that they are descriptive rather than analytical. They do a good job of describing the historical evolution of FDI, but they do a relatively poor job of identifying the factors that influence the relative profitability of FDI, licensing, and exporting. Indeed, the issue of licensing as an alternative to FDI is ignored by both of these theories.

GOVERNMENT POLICY

A host government's attitude toward FDI should be an important variable in decisions about where to locate foreign production facilities and where to make a foreign direct investment. Other things being equal, investing in countries that have permissive policies toward FDI is clearly preferable to investing in countries that restrict FDI.

However, often the issue is not this straightforward. Despite the move toward a free market stance in recent years, many countries still have a rather pragmatic stance toward FDI. In such cases, a firm considering FDI must often negotiate the specific terms of the investment with the country's government. Such negotiations center on two broad issues. If the host government is trying to attract FDI, the central issue is likely to be the kind of incentives the host government is prepared to offer to the MNE and what the firm will commit in exchange. If the host government is uncertain about the benefits of FDI and might choose to restrict access, the central issue is likely to be the concessions that the firm must make to be allowed to go forward with a proposed investment.

To a large degree, the outcome of any negotiated agreement depends on the relative bargaining power of both parties. Each side's bargaining power depends on three factors:

- The value each side places on what the other has to offer.
- The number of comparable alternatives available to each side.
- Each party's time horizon.

From the perspective of a firm negotiating the terms of an investment with a host government, the firm's bargaining power is high when the host government places a high value on what the firm has to offer, the number of comparable alternatives open to the firm is greater, and the firm has a long time in which to complete the negotiations. The converse also holds. The firm's bargaining power is low when the host government places a low value on what the firm has to offer, the number of comparable alternatives open to the firm is fewer, and the firm has a short time in which to complete the negotiations.[54]

CHAPTER SUMMARY

This chapter reviewed theories that attempt to explain the pattern of FDI between countries and to examine the influence of governments on firms' decisions to invest in foreign countries. The chapter made the following points:

1. Any theory seeking to explain FDI must explain why firms go to the trouble of acquiring or establishing operations abroad, when the alternatives of exporting and licensing are available to them.
2. High transportation costs or tariffs imposed on imports help explain why many firms prefer FDI or licensing over exporting.
3. Firms often prefer FDI to licensing when: (*a*) a firm has valuable know-how that cannot be adequately protected by a licensing contract, (*b*) a firm needs tight control over a foreign entity in order to maximize its market share and earnings in that country, and (*c*) a firm's skills and capabilities are not amenable to licensing.
4. Knickerbocker's theory suggests that much FDI is explained by imitative behavior by rival firms in an oligopolistic industry.
5. Vernon's product life-cycle theory suggests that firms undertake FDI at particular stages in the life cycle of products they have pioneered. However, Vernon's theory does not address the issue of whether FDI is more efficient than exporting or licensing for expanding abroad.
6. Dunning has argued that location-specific advantages are of considerable importance in explaining the nature and direction of FDI. According to Dunning, firms undertake FDI to exploit resource endowments or assets that are location specific.
7. Political ideology is an important determinant of government policy toward FDI. Ideology ranges from a radical stance that is hostile to FDI to a noninterventionist, free market stance. Between the two extremes is an approach best described as pragmatic nationalism.
8. Benefits of FDI to a host country arise from resource transfer effects, employment effects, and balance-of-payments effects.
9. The costs of FDI to a host country include adverse effects on competition and balance of payments and a perceived loss of national sovereignty.
10. The benefits of FDI to the home (source) country include improvement in the balance of payments as a result of the inward flow of foreign earnings, positive employment effects when the foreign subsidiary creates demand for home-country exports, and benefits from a reverse resource-transfer effect. A reverse resource-transfer effect arises when the foreign subsidiary learns valuable skills abroad that can be transferred back to the home country.
11. The costs of FDI to the home country include adverse balance-of-payments effects that arise from the initial capital outflow and from the export substitution effects of FDI. Costs also arise when FDI exports jobs abroad.
12. Home countries can adopt policies designed to both encourage and restrict FDI. Host countries try to attract FDI by offering incentives and try to restrict FDI by dictating ownership restraints and requiring that foreign MNEs meet specific performance requirements.

Critical Thinking and Discussion Questions

1. In 2004, inward FDI accounted for some 24 percent of gross fixed capital formation in Ireland, but only 0.6 percent in Japan. What do you think explains this difference in FDI inflows into the two countries?
2. Compare and contrast these explanations of FDI: internalization theory, Vernon's product life-cycle theory, and Knickerbocker's theory of FDI. Which theory do you think offers the best explanation of the historical pattern of FDI? Why?
3. Read the Management Focus on Cemex and then answer the following questions:
   a. Which theoretical explanation, or explanations, of FDI best explains Cemex's FDI?
   b. What is the value that Cemex brings to a host economy? Can you see any potential drawbacks of inward investment by Cemex in an economy?
   c. Cemex has a strong preference for acquisitions over greenfield ventures as an entry mode. Why?

4. You are the international manager of a U.S. business that has just developed a revolutionary new personal computer that can perform the same functions as existing PCs but costs only half as much to manufacture. Several patents protect the unique design of this computer. Your CEO has asked you to formulate a recommendation for how to expand into Western Europe. Your options are (*a*) to export from the United States, (*b*) to license a European firm to manufacture and market the computer in Europe, or (*c*) to set up a wholly owned subsidiary in Europe. Evaluate the pros and cons of each alternative and suggest a course of action to your CEO.

Research Task globalEDGE globaledge.msu.edu

Foreign Direct Investment

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The *World Investment Report* published annually by UNCTAD provides quick electronic access to comprehensive statistics on the operations of the largest transnational corporations. Gather a list of the top 10 non-financial transnational corporations from developing countries. Provide a summary of the countries and industries represented. Do you notice any common traits from your analysis?

Exercise 2

An integral part of successful foreign direct investment (FDI) is to understand the target market as well as the nature of the possible investment sector. As such, your energy company is seeking FDI opportunities in Jordan. The *Multilaterial Investment Guarantee Agency* has been identified as a resource to examine the energy industry internationally. Based on the information available at this resource, prepare a report indicating recent and important trends relevant to a possible FDI venture in Jordan.

CLOSING CASE

Spain's Telefonica

Established in the 1920s, Spain's Telefonica was a typical state-owned national telecommunications monopoly until the 1990s. Then the Spanish government privatized the company and deregulated the Spanish telecommunications market. What followed was a sharp reduction in the workforce, rapid adoption of new technology, and focus on driving up profits and shareholder value.

In this new era, Telefonica was looking for growth. Its search first took it to Latin America. There, too, a wave of deregulation and privatization was sweeping across the region. For Telefonica, Latin America seemed to be the perfect fit. Much of the region shared a common language and had deep cultural and historical ties to Spain. Also, after decades of slow growth, Latin American markets were growing rapidly, increasing the adoption rate and usage not just of traditional fixed line telecommunications services, but also of mobile phones and Internet connections.

Having already learned to transform itself from a state-owned enterprise into an efficient and effective competitor, Telefonica believed it could do the same for companies it acquired in Latin America, many of which were once part of state-owned telecommunications monopolies. In the late 1990s, Telefonica invested some $11 billion in Latin America, acquiring companies throughout the region. Its largest investments were reserved for Brazil, the biggest market in the region, where it spent some $6 billion to purchase several companies, including the largest fixed line operator in São Paulo, the leading mobile phone operator in Rio de Janeiro, and the principal carrier in the state of Rio Grande do Sul. In Argentina, it acquired 51 percent of the southern region's monopoly provider, a franchise that included the lucrative financial district of Buenos Aires. In Chile, it became the leading shareholder in the former state-owned monopoly, and so on. Indeed, by the early 2000s Telefonica was the No. 1 or 2 player in almost every Latin American country, had a continent-wide market share of about 40 percent, and was generating 18 percent of its revenues from the region.

Still, for all of its investment, Telefonica has not had it all its own way in Latin America. Other companies could also see the growth opportunities, and several foreign telecommunications enterprises entered Latin America's newly opened markets. In the fast-growing mobile segment, America Movil, controlled by the Mexican billionaire Carlos Slim, emerged as a strong challenger. By 2008, the Mexican company had 182 million wireless subscribers across Latin America, compared to Telefonica's 123 million, and intense price competition between the two companies was emerging.

With the die already cast in Latin America by the mid-2000s, Telefonica turned its attention to neighboring countries in Europe. For years, there had been a tacit agreement between national telecommunications companies that they would not invade each other's markets. In 2005 this started to break down when France Telecom entered Spain, purchasing Amena, the country's second-largest mobile carrier behind Telefonica. Telefonica moved quickly to make its own European acquisition, acquiring Britain's major mobile phone operator, O2, for $31.4 billion. O2 already had significant operations in Germany as well as the United Kingdom. The acquisition transformed Telefonica into the second-largest mobile phone operator in the world, measured by customers, behind China Mobile.[55]

Case Discussion Questions

1. What changes in the political and economic environment allowed Telefonica to start expanding globally?
2. Why did Telefonica initially focus on Latin America? Why was it slower to expand in Europe, even though Spain is a member of the European Union?
3. Telefonica has used acquisitions, rather than greenfield ventures, as its entry strategy. Why do you think this has been the case? What are the potential risks associated with this entry strategy?
4. What is the value that Telefonica brings to the companies it acquires?
5. In your judgment, does inward investment by Telefonica benefit a host nation? Explain your reasoning?

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9 Regional Economic Integration

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Describe the different levels of regional economic integration.
- **LO2** Understand the economic and political arguments for regional economic integration.
- **LO3** Understand the economic and political arguments against regional economic integration.
- **LO4** Explain the history, current scope, and future prospects of the world's most important regional economic agreements.
- **LO5** Understand the implications for business that are inherent in regional economic integration agreements.

I Want My Greek TV!

It's now almost two decades since the member states of the European Union started to implement a treaty calling for the establishment of a single market for goods and services across the union, and yet progress toward this goal is still not complete. A case in point: the TV broadcasts of Premier League soccer. The English Premier League, which is one of the most lucrative broadcasting sports franchises in Europe, if not the world, has for years segmented Europe into different national markets, charging different prices for broadcasting rights depending on local demand. Not surprisingly, the rights are most expensive in the United Kingdom where the league has contracted with British Sky Broadcasting Group and ESPN to screen games.

Karen Murphy, the owner of the Red, White and Blue pub in Portsmouth, England, didn't want to pay the £7,000 annual subscription fee that Sky demanded for access to the Premier League feed. Instead, she purchased a TV signal decoder card and used it to unscramble the feed from a Greek TV broadcaster, Nova, which had purchased the rights to broadcasting Premier League soccer in Greece. This cost her just £800 a year. In 2005, it also brought down a lawsuit from the Premier League. The initial judgment in a British court upheld the right of the Premier League to segment the market and charge a higher price to UK subscribers. Murphy was fined £8,000. She appealed the ruling, claiming the practice violated the EU's Single Market Act, which the United Kingdom had signed in 1992.

The case eventually landed in the European Court of Justice, the EU's highest court. The Premier League argued before the court that the EU needs individual national TV markets to satisfy the "cultural preferences" of viewers. The court did not agree. In a bombshell for the Premier



League, on February 3, 2011, the court stated, "Territorial exclusivity agreements relating to the transmission of football matches are contrary to European Union Law. European Law does not make it possible to prohibit the live transmission of Premier League matches in pubs by means of foreign decoder cards." In short, Murphy can continue to purchase her feed from Nova. This decision was a legal opinion prepared by the court's advocate general, so technically it is still possible that the full court might overturn it, but in four out of five cases this does not happen.

This was not the first time the court had issued a ruling that impacted Premier League soccer. In 1995, the court upheld the right of a Belgian soccer player to play in another EU country, stating athletes had the same freedom of movement as other EU workers. Ironically, this ruling, which also affirmed the principle of a single market, benefited Premier League clubs, enabling them to sign foreign players, rapidly transforming the league into the best in the world. The new ruling, however, creates significant challenges for the league. Revenue from broadcasting is a major source of income for Premier League clubs. The current deal giving British broadcasting rights to Sky and ESPN is worth some £1.782 billion to the league between 2010 and 2013. If the ruling is affirmed, many consumers may follow Murphy and buy TV decoders so that they can watch lower-cost feeds. If enough do this, the income loss from arbitrage by consumers may force the Premier League to move toward pan-European broadcasting and pricing. This will reduce income to the clubs, which could have a profound impact on the players they can recruit and the wages they can afford. In short, the ruling, while benefiting consumers such as Murphy and her customers at the Red, White and Blue pub, is a dark cloud hanging over the future of British soccer.[1]

Introduction

This chapter takes a close look at the arguments for regional economic integration through the establishment of trading blocs such as the European Union and the North American Free Trade Agreement. By **regional economic integration** we mean agreements among countries in a geographic region to reduce, and ultimately remove, tariff and nontariff barriers to the free flow of goods, services, and factors of production between each other. The opening case illustrates some of the issues surrounding the creation of a trading bloc. By creating a single market, the EU aimed to lower the price for goods and services across the bloc. Such a policy is good for consumers, since it lowers prices, but it presents challenges to some producers who have to adapt to a more competitive environment. In the case of broadcasting rights for Premier League soccer, adopting a single market approach, as required by EU law, means the league cannot stop consumers in one country from subscribing to TV feeds from another country where the price is lower. While this is good for consumers, it reduces the value of Premier League broadcasting rights, driving down the income to Premier League clubs and hence the players they can afford to recruit and the salaries they can afford to pay. Thus, as with free trade in general, regional economic integration creates gain for consumers, but it can be challenging for some producers.

The past two decades have witnessed an unprecedented proliferation of regional trade blocs that promote regional economic integration. World Trade Organization members are required to notify the WTO of any regional trade agreements in which they participate. By 2010, nearly all of the WTO's members had notified the organization of participation in one or more regional trade agreements. The total number of regional trade agreements currently in force is around 400.[2]

Consistent with the predictions of international trade theory and particularly the theory of comparative advantage (see Chapter 6), agreements designed to promote freer trade within regions are believed to produce gains from trade for all member countries. As we saw in Chapter 7, the General Agreement on Tariffs and Trade and its successor, the World Trade Organization, also seek to reduce trade barriers. With 153 member states, the WTO has a worldwide perspective. By entering into regional agreements, groups of countries aim to reduce trade barriers more rapidly than can be achieved under the auspices of the WTO.

Nowhere has the movement toward regional economic integration been more successful than in Europe. On January 1, 1993, the European Union (EU) formally removed many barriers to doing business across borders within the EU in an attempt to create a single market with 340 million consumers. However, the EU did not stop there. The member states of the EU have launched a single currency, the euro; they are moving toward a closer political union. On May 1, 2004, the EU expanded from 15 to 25 countries and in 2007 two more countries joined, Bulgaria and Romania, making the total 27. Today, the EU has a population of almost 500 million and a gross domestic product of €12 trillion ($15.7 trillion), making it larger than the United States in economic terms.

Similar moves toward regional integration are being pursued elsewhere in the world. Canada, Mexico, and the United States have implemented the North American Free Trade Agreement (NAFTA). Ultimately, this promises to remove all barriers to the free flow of goods and services between the three countries. While the implementation of NAFTA has resulted in job losses in some sectors of the American economy, in aggregate and consistent with the predictions of international trade theory, most economists argue that the benefits of greater regional trade outweigh any costs. South America, too, has moved toward regional integration. In 1991, Argentina, Brazil, Paraguay, and Uruguay implemented an agreement known as Mercosur to start reducing barriers to trade between each other, and although progress within Mercosur has been halting, the institution is still in place. There are also active attempts at regional economic integration in Central America, the Andean region of South America, Southeast Asia, and parts of Africa.

While the move toward regional economic integration is generally seen as a good thing, some observers worry that it will lead to a world in which regional trade blocs compete against each other. In this possible future scenario, free trade will exist within each bloc, but each bloc will protect its market from outside competition with high tariffs. The specter of the EU and NAFTA turning into economic fortresses that shut out foreign producers through high tariff barriers is worrisome to those who believe in unrestricted free trade. If such a situation were to materialize, the resulting decline in trade between blocs could more than offset the gains from free trade within blocs.

With these issues in mind, this chapter will explore the economic and political debate surrounding regional economic integration, paying particular attention to the economic and political benefits and costs of integration; review progress toward regional economic integration around the world; and map the important implications of regional economic integration for the practice of international business. Before tackling these objectives, we first need to examine the levels of integration that are theoretically possible.

Levels of Economic Integration

LO1

Several levels of economic integration are possible in theory (see Figure 9.1). From least integrated to most integrated, they are a free trade area, a customs union, a common market, an economic union, and, finally, a full political union.

In a **free trade area**, all barriers to the trade of goods and services among member countries are removed. In the theoretically ideal free trade area, no discriminatory tariffs, quotas, subsidies, or administrative impediments are allowed to distort trade between members. Each country, however, is allowed to determine its own trade policies with regard to nonmembers. Thus, for example, the tariffs placed on the products of nonmember countries may vary from member to member. Free trade agreements are the most popular form of regional economic integration, accounting for almost 90 percent of regional agreements.[3]

The most enduring free trade area in the world is the **European Free Trade Association (EFTA)**. Established in January 1960, EFTA currently joins four countries—

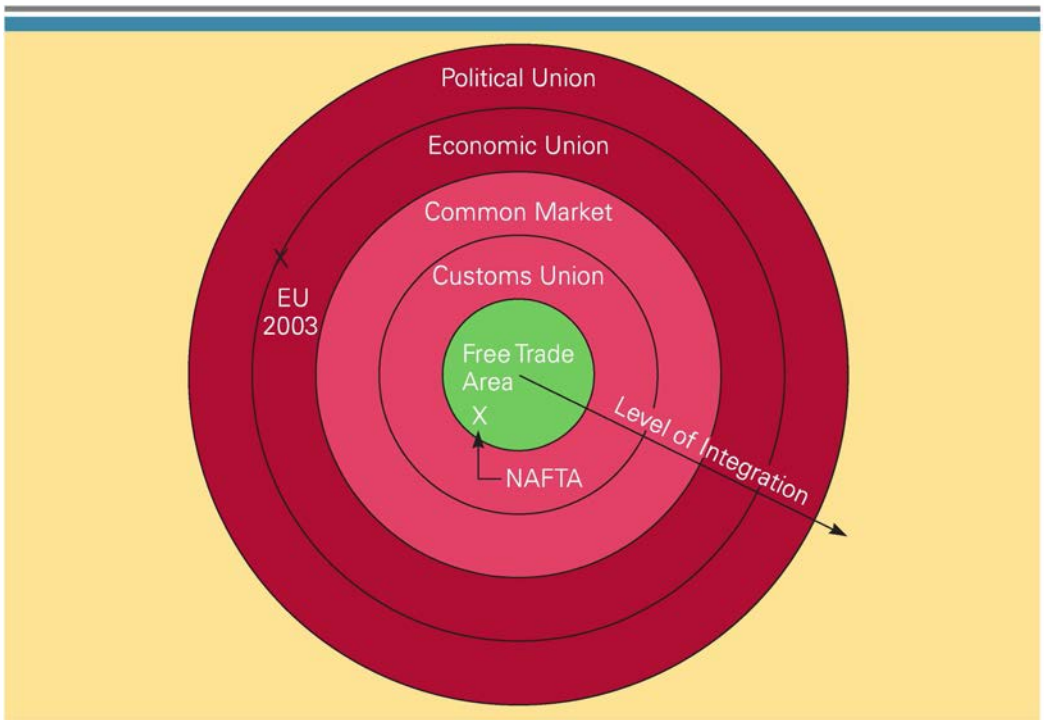

FIGURE 9.1
Levels of Economic Integration

Norway, Iceland, Liechtenstein, and Switzerland—down from seven in 1995 (three EFTA members, Austria, Finland, and Sweden, joined the EU on January 1, 1996). EFTA was founded by those Western European countries that initially decided not to be part of the European Community (the forerunner of the EU). Its original members included Austria, Great Britain, Denmark, Finland, and Sweden, all of which are now members of the EU. The emphasis of EFTA has been on free trade in industrial goods. Agriculture was left out of the arrangement, each member being allowed to determine its own level of support. Members are also free to determine the level of protection applied to goods coming from outside EFTA. Other free trade areas include the North American Free Trade Agreement, which we shall discuss in depth later in the chapter.

The customs union is one step farther along the road to full economic and political integration. A **customs union** eliminates trade barriers between member countries and adopts a common external trade policy. Establishment of a common external trade policy necessitates significant administrative machinery to oversee trade relations with nonmembers. Most countries that enter into a customs union desire even greater economic integration down the road. The EU began as a customs union, but has now moved beyond this stage. Other customs unions around the world include the current version of the Andean Community (formerly known as the Andean Pact) between Bolivia, Colombia, Ecuador, Peru, and Venezuela. The Andean Community established free trade between member countries and imposes a common tariff, of 5 to 20 percent, on products imported from outside.[4]

The next level of economic integration, a **common market**, has no barriers to trade between member countries, includes a common external trade policy, and allows factors of production to move freely between members. Labor and capital are free to move because there are no restrictions on immigration, emigration, or cross-border flows of capital between member countries. Establishing a common market demands a significant degree of harmony and cooperation on fiscal, monetary, and employment policies. Achieving this degree of cooperation has proven very difficult. For years, the European Union functioned as a common market, although it has now moved beyond this stage. Mercosur, the South American grouping of Argentina, Brazil, Paraguay, and Uruguay (Venezuela has also applied to join), hopes to eventually establish itself as a common market.

An economic union entails even closer economic integration and cooperation than a common market. Like the common market, an **economic union** involves the free flow of products and factors of production between member countries and the adoption of a common external trade policy, but it also requires a common currency, harmonization of members' tax rates, and a common monetary and fiscal policy. Such a high degree of integration demands a coordinating bureaucracy and the sacrifice of significant amounts of national sovereignty to that bureaucracy. The EU is an economic union, although an imperfect one because not all members of the EU have adopted the euro, the currency of the EU; differences in tax rates and regulations across countries still remain; and some markets, such as the market for energy, are still not fully deregulated.

The move toward economic union raises the issue of how to make a coordinating bureaucracy accountable to the citizens of member nations. The answer is through **political union** in which a central political apparatus coordinates the economic, social, and foreign policy of the member states. The EU is on the road toward at least partial political union. The European Parliament, which is playing an ever more important role in the EU, has been directly elected by citizens of the EU countries since the late 1970s. In addition, the Council of Ministers (the controlling, decision-making body of the EU) is composed of government ministers from each EU member. The United States provides an example of even closer political union; in the United States, independent states are effectively combined into a single nation. Ultimately, the EU may move toward a similar federal structure.

The Case for Regional Integration LO2

The case for regional integration is both economic and political, and it is typically not accepted by many groups within a country, which explains why most attempts to achieve regional economic integration have been contentious and halting. In this section, we examine the economic and political cases for integration and two impediments to integration. In the next section, we look at the case against integration.

THE ECONOMIC CASE FOR INTEGRATION

The economic case for regional integration is straightforward. We saw in Chapter 6 how economic theories of international trade predict that unrestricted free trade will allow countries to specialize in the production of goods and services that they can produce most efficiently. The result is greater world production than would be possible with trade restrictions. That chapter also revealed how opening a country to free trade stimulates economic growth, which creates dynamic gains from trade. Chapter 8 detailed how foreign direct investment (FDI) can transfer technological, marketing, and managerial know-how to host nations. Given the central role of knowledge in stimulating economic growth, opening a country to FDI also is likely to stimulate economic growth. In sum, economic theories suggest that free trade and investment is a positive-sum game, in which all participating countries stand to gain.

Given this, the theoretical ideal is an absence of barriers to the free flow of goods, services, and factors of production among nations. However, as we saw in Chapters 7 and 8, a case can be made for government intervention in international trade and FDI. Because many governments have accepted part or all of the case for intervention, unrestricted free trade and FDI have proved to be only an ideal. Although international institutions such as the WTO have been moving the world toward a free trade regime, success has been less than total. In a world of many nations and many political ideologies, it is very difficult to get all countries to agree to a common set of rules.

Against this background, regional economic integration can be seen as an attempt to achieve additional gains from the free flow of trade and investment between countries beyond those attainable under international agreements such as the WTO. It is easier to establish a free trade and investment regime among a limited number of adjacent countries than among the world community. Coordination and policy harmonization problems are largely a function of the number of countries that seek agreement. The greater the number of countries involved, the more perspectives that must be reconciled, and the harder it will be to reach agreement. Thus, attempts at regional economic integration are motivated by a desire to exploit the gains from free trade and investment.

THE POLITICAL CASE FOR INTEGRATION

The political case for regional economic integration also has loomed large in several attempts to establish free trade areas, customs unions, and the like. Linking neighboring economies and making them increasingly dependent on each other creates incentives for political cooperation between the neighboring states and reduces the potential for violent conflict. In addition, by grouping their economies, the countries can enhance their political weight in the world.

These considerations underlay the 1957 establishment of the European Community (EC), the forerunner of the EU. Europe had suffered two devastating wars in the first half of the twentieth century, both arising out of the unbridled ambitions of nation-states. Those who have sought a united Europe have always had a desire to make another war in Europe unthinkable. Many Europeans also believed that after World War II, the European nation-states were no longer large enough to hold their own in world markets and politics. The need for a united Europe to deal with the United States and the politically alien Soviet Union loomed large in the minds of many of the EC's

founders.[5] A long-standing joke in Europe is that the European Commission should erect a statue to Joseph Stalin, for without the aggressive policies of the former dictator of the old Soviet Union, the countries of Western Europe may have lacked the incentive to cooperate and form the EC.

IMPEDIMENTS TO INTEGRATION

Despite the strong economic and political arguments in support, integration has never been easy to achieve or sustain for two main reasons. First, although economic integration aids the majority, it has its costs. While a nation as a whole may benefit significantly from a regional free trade agreement, certain groups may lose. Moving to a free trade regime involves painful adjustments. For example, due to the 1994 establishment of NAFTA, some Canadian and U.S. workers in such industries as textiles, which employ low-cost, low-skilled labor, lost their jobs as Canadian and U.S. firms moved production to Mexico. The promise of significant net benefits to the Canadian and U.S. economies as a whole is little comfort to those who lose as a result of NAFTA. Such groups have been at the forefront of opposition to NAFTA and will continue to oppose any widening of the agreement.

A second impediment to integration arises from concerns over national sovereignty. For example, Mexico's concerns about maintaining control of its oil interests resulted in an agreement with Canada and the United States to exempt the Mexican oil industry from any liberalization of foreign investment regulations achieved under NAFTA. Concerns about national sovereignty arise because close economic integration demands that countries give up some degree of control over such key issues as monetary policy, fiscal policy (e.g., tax policy), and trade policy. This has been a major stumbling block in the EU. To achieve full economic union, the EU introduced a common currency, the euro, controlled by a central EU bank. Although most member states have signed on, Great Britain remains an important holdout. A politically important segment of public opinion in that country opposes a common currency on the grounds that it would require relinquishing control of the country's monetary policy to the EU, which many British perceive as a bureaucracy run by foreigners. In 1992, the British won the right to opt out of any single currency agreement, and as of 2011, the British government had yet to reverse its decision and did not seem likely to.

LO3 The Case Against Regional Integration

Although the tide has been running in favor of regional free trade agreements in recent years, some economists have expressed concern that the benefits of regional integration have been oversold, while the costs have often been ignored.[6] They point out that the benefits of regional integration are determined by the extent of trade creation, as opposed to trade diversion. **Trade creation** occurs when high-cost domestic producers are replaced by low-cost producers within the free trade area. It may also occur when higher-cost external producers are replaced by lower-cost external producers within the free trade area. **Trade diversion** occurs when lower-cost external suppliers are replaced by higher-cost suppliers within the free trade area. A regional free trade agreement will benefit the world only if the amount of trade it creates exceeds the amount it diverts.

Suppose the United States and Mexico imposed tariffs on imports from all countries, and then they set up a free trade area, scrapping all trade barriers between themselves but maintaining tariffs on imports from the rest of the world. If the United States began to import textiles from Mexico, would this change be for the better? If the United States previously produced all its own textiles at a higher cost than Mexico, then the free trade agreement has shifted production to the cheaper source. According to the theory of comparative advantage, trade has been created within the regional grouping, and there would be no decrease in trade with the rest of the world. Clearly, the change would be for

the better. If, however, the United States previously imported textiles from Costa Rica, which produced them more cheaply than either Mexico or the United States, then trade has been diverted from a low-cost source—a change for the worse.

In theory, WTO rules should ensure that a free trade agreement does not result in trade diversion. These rules allow free trade areas to be formed only if the members set tariffs that are not higher or more restrictive to outsiders than the ones previously in effect. However, as we saw in Chapter 7, GATT and the WTO do not cover some nontariff barriers. As a result, regional trade blocs could emerge whose markets are protected from outside competition by high nontariff barriers. In such cases, the trade diversion effects might outweigh the trade creation effects. The only way to guard against this possibility, according to those concerned about this potential, is to increase the scope of the WTO so it covers nontariff barriers to trade. There is no sign that this is going to occur anytime soon, however, so the risk remains that regional economic integration will result in trade diversion.

Regional Economic Integration in Europe LO4

Europe has two trade blocs—the European Union and the European Free Trade Association. Of the two, the EU is by far the more significant, not just in terms of membership (the EU currently has 27 members; the EFTA has 4), but also in terms of economic and political influence in the world economy. Many now see the EU as an emerging economic and political superpower of the same order as the United States. Accordingly, we will concentrate our attention on the EU.[7]

EVOLUTION OF THE EUROPEAN UNION

The **European Union** (EU) is the product of two political factors: (1) the devastation of Western Europe during two world wars and the desire for a lasting peace, and (2) the European nations' desire to hold their own on the world's political and economic stage. In addition, many Europeans were aware of the potential economic benefits of closer economic integration of the countries.

The forerunner of the EU, the European Coal and Steel Community, was formed in 1951 by Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands. Its objective was to remove barriers to intragroup shipments of coal, iron, steel, and scrap metal. With the signing of the **Treaty of Rome** in 1957, the European Community was established. The name changed again in 1994 when the European Community became the European Union following the ratification of the Maastricht Treaty (discussed later).

The Treaty of Rome provided for the creation of a common market. Article 3 of the treaty laid down the key objectives of the new community, calling for the elimination of internal trade barriers and the creation of a common external tariff and requiring member states to abolish obstacles to the free movement of factors of production among the members. To facilitate the free movement of goods, services, and factors of production, the treaty provided for any necessary harmonization of the member states' laws. Furthermore, the treaty committed the EC to establish common policies in agriculture and transportation.

The community grew in 1973, when Great Britain, Ireland, and Denmark joined. These three were followed in 1981 by Greece, in 1986 by Spain and Portugal, and in 1996 by Austria, Finland, and Sweden, bringing the total membership to 15 (East Germany became part of the EC after the reunification of Germany in 1990). Another 10 countries joined the EU on May 1, 2004, 8 of them from Eastern Europe plus the small Mediterranean nations of Malta and Cyprus, and Bulgaria and Romania joined in 2007, bringing the total number of member states to 27 (see Map 9.1). With a population of almost 500 million and a GDP of €12 trillion, larger than that of the United States, the EU through these enlargements has become a global superpower.[8]



MAP 9.1

Member States of the European Union in 2011

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POLITICAL STRUCTURE OF THE EUROPEAN UNION

The economic policies of the EU are formulated and implemented by a complex and still-evolving political structure. The four main institutions in this structure are the European Commission, the Council of the European Union, the European Parliament, and the Court of Justice.[9]

The **European Commission** is responsible for proposing EU legislation, implementing it, and monitoring compliance with EU laws by member states. Headquartered in Brussels, Belgium, the commission has more than 24,000 employees. It is run by a group of commissioners appointed by each member country for five-year renewable terms. There are 27 commissioners, one from each member state. A president of the commission is chosen by member states, and the president then chooses other members in consultation with the states. The entire commission has to be approved by the European Parliament before it can begin work. The commission has a monopoly in proposing European Union legislation. The commission makes a proposal, which goes to the Council of the European Union and then to the European Parliament. The council cannot legislate

without a commission proposal in front of it. The commission is also responsible for implementing aspects of EU law, although in practice much of this must be delegated to member states. Another responsibility of the commission is to monitor member states to make sure they are complying with EU laws. In this policing role, the commission will normally ask a state to comply with any EU laws that are being broken. If this persuasion is not sufficient, the commission can refer a case to the Court of Justice.

The European Commission's role in competition policy has become increasingly important to business in recent years. Since 1990 when the office was formally assigned a role in competition policy, the EU's competition commissioner has been steadily gaining influence as the chief regulator of competition policy in the member nations of the EU. As with antitrust authorities in the United States, which include the Federal Trade Commission and the Department of Justice, the role of the competition commissioner is to ensure that no one enterprise uses its market power to drive out competitors and monopolize markets. The commissioner also reviews proposed mergers and acquisitions to make sure they do not create a dominant enterprise with substantial market power.[10] For example, in 2000 a proposed merger between Time Warner of the United States and EMI of the United Kingdom, both music recording companies, was withdrawn after the commission expressed concerns that the merger would reduce the number of major record companies from five to four and create a dominant player in the $40 billion global music industry. Similarly, the commission blocked a proposed merger between two U.S. telecommunication companies, WorldCom and Sprint, because their combined holdings of Internet infrastructure in Europe would give the merged companies so much market power that the commission argued the combined company would dominate that market. Another example of the commission's influence over business combinations is given in the accompanying Management Focus, which looks at the commission's role in shaping mergers and joint ventures in the media industry.

The **European Council** represents the interests of member states. It is clearly the ultimate controlling authority within the EU since draft legislation from the commission can become EU law only if the council agrees. The council is composed of one representative from the government of each member state. The membership, however, varies depending on the topic being discussed. When agricultural issues are being discussed, the agriculture ministers from each state attend council meetings; when transportation is being discussed, transportation ministers attend, and so on. Before 1993, all council issues had to be decided by unanimous agreement between member states. This often led to marathon council sessions and a failure to make progress or reach agreement on commission proposals. In an attempt to clear the resulting logjams, the Single European Act formalized the use of majority voting rules on issues "which have as their object the establishment and functioning of a single market." Most other issues, however, such as tax regulations and immigration policy, still require unanimity among council members if they are to become law. The votes that a country gets in the council are related to the size of the country. For example, Britain, a large country, has 29 votes, whereas Denmark, a much smaller state, has 7 votes.

The **European Parliament**, which now has 732 members, is directly elected by the populations of the member states. The parliament, which meets in Strasbourg, France, is primarily a consultative rather than legislative body. It debates legislation proposed by the commission and forwarded to it by the council. It can propose amendments to that legislation, which the commission and ultimately the council are not obliged to take up but often will. The power of the parliament recently has been increasing, although not by as much as parliamentarians would like. The European Parliament now has the right to vote on the appointment of commissioners as well as veto some laws (such as the EU budget and single-market legislation).

One major debate waged in Europe during the past few years is whether the council or the parliament should ultimately be the most powerful body in the EU. Some in Europe expressed concern over the democratic accountability of the EU bureaucracy. One side argued that the answer to this apparent democratic deficit lay in increasing the power of



MANAGEMENT FOCUS

The European Commission and Media Industry Mergers

In late 1999, U.S. Internet giant AOL announced it would merge with the music and publishing conglomerate Time Warner. Both the U.S. companies had substantial operations in Europe. The European commissioner for competition, Mario Monti, announced the commission would investigate the impact of the merger on competition in Europe.

The investigation took on a new twist when Time Warner subsequently announced it would form a joint venture with British-based EMI. Time Warner and EMI are two of the top five music publishing companies in the world. The proposed joint venture would have been three times as large as its nearest global competitor. The European Commission now had two concerns. The first was that the joint venture between EMI and Time Warner would reduce the level of competition in the music publishing industry. The second was that a combined AOL–Time Warner would dominate the emerging market for downloading music over the Internet, particularly given the fact that AOL would be able to gain preferential access to the music libraries of both Warner and EMI. This would potentially put other online service providers at a disadvantage. The commission was also concerned that AOL Europe was a joint venture between AOL and Bertelsmann, a German media company that also had considerable music publishing interests. Accordingly, the commission announced it would undertake a separate investigation of the proposed deal between Time Warner and EMI.

These investigations continued into late 2000 and were resolved by a series of concessions extracted by the European Commission. First, under pressure from the commission, Time Warner and EMI agreed to drop their proposed joint venture, thereby maintaining the level of competition in the music publishing business. Second, AOL and Time Warner agreed to allow rival Internet service providers access to online music on the same terms as AOL would receive from Warner Music Group for the next five years. Third, AOL agreed to sever all ties with Bertelsmann, and the German company agreed to withdraw from AOL Europe. These developments alleviated the commission's concern that the AOL–Time Warner combination would dominate the emerging market for the digital download of music. With these concessions in hand, the commission approved the AOL–Time Warner merger in early October 2000.

By late 2000 the AOL–Time Warner merger had been completed. The shape of the media business, both in Europe and worldwide, now looked very different, and the European Commission had played a pivotal role in determining the outcome. Its demand for concessions altered the strategy of several companies, led to somewhat different combinations from those originally planned, and, the commission believed, preserved competition in the global media business.[11]

the parliament, while others think that true democratic legitimacy lies with elected governments, acting through the Council of the European Union.[12] After significant debate, in December 2007 the member states signed a new treaty, the **Treaty of Lisbon**, under which the power of the European Parliament is increased. When it took effect in December 2009, for the first time in history the European Parliament was the co-equal legislator for almost all European laws.[13] The Treaty of Lisbon also creates a new position, a president of the European Council, who serves a 30-month term and represents the nation-states that make up the EU. Under the treaty, the European Commission was reduced to 18 members, with a rotation system that ensures that every member state has regular and equal membership.

The **Court of Justice**, which is comprised of one judge from each country, is the supreme appeals court for EU law. Like commissioners, the judges are required to act as independent officials, rather than as representatives of national interests. The commission or a member country can bring other members to the court for failing to meet treaty obligations. Similarly, member countries, companies, or institutions can bring the commission or council to the court for failure to act according to an EU treaty.

THE SINGLE EUROPEAN ACT

The Single European Act was born of a frustration among members that the community was not living up to its promise. By the early 1980s, it was clear that the EC had fallen short of its objectives to remove barriers to the free flow of trade and investment between member countries and to harmonize the wide range of technical and legal standards for doing business. Against this background, many of the EC's prominent businesspeople mounted an energetic campaign in the early 1980s to end the EC's economic divisions. The EC responded by creating the Delors Commission. Under the chairmanship of Jacques Delors, the commission proposed that all impediments to the formation of a single market be eliminated by December 31, 1992. The result was the Single European Act, which was independently ratified by the parliaments of each member country and became EC law in 1987.

The Objectives of the Act

The purpose of the Single European Act was to have one market in place by December 31, 1992. The act proposed the following changes:[14]

- Remove all frontier controls between EC countries, thereby abolishing delays and reducing the resources required for complying with trade bureaucracy.
- Apply the principle of "mutual recognition" to product standards. A standard developed in one EC country should be accepted in another, provided it meets basic requirements in such matters as health and safety.
- Open public procurement to nonnational suppliers, reducing costs directly by allowing lower-cost suppliers into national economies and indirectly by forcing national suppliers to compete.
- Lift barriers to competition in the retail banking and insurance businesses, which should drive down the costs of financial services, including borrowing, throughout the EC.
- Remove all restrictions on foreign exchange transactions between member countries by the end of 1992.
- Abolish restrictions on cabotage—the right of foreign truckers to pick up and deliver goods within another member state's borders—by the end of 1992. Estimates suggested this would reduce the cost of haulage within the EC by 10 to 15 percent.

All those changes were predicted to lower the costs of doing business in the EC, but the single-market program was also expected to have more complicated supply-side effects. For example, the expanded market was predicted to give EC firms greater opportunities to exploit economies of scale. In addition, it was thought that the increase in competitive intensity brought about by removing internal barriers to trade and investment would force EC firms to become more efficient. To signify the importance of the Single European Act, the European Community also decided to change its name to the European Union once the act took effect.

Impact

The Single European Act has had a significant impact on the EU economy.[15] The act provided the impetus for the restructuring of substantial sections of European industry. Many firms have shifted from national to pan-European production and distribution systems in an attempt to realize scale economies and better compete in a single market. The results have included faster economic growth than would otherwise have been the case.

However, 20 years after the formation of a single market, the reality still falls short of the ideal. In the opening case, for example, we saw how until 2011 sports organizations such as soccer's Premier League had still been able to segment the EU into different

COUNTRY FOCUS

Creating a Single Market in Financial Services

The European Union in 1999 embarked upon an ambitious action plan to create a single market in financial services by January 1, 2005. Launched a few months after the euro, the EU's single currency, the goal was to dismantle barriers to cross-border activity in financial services, creating a continentwide market for banking service, insurance services, and investment products. In this vision of a single Europe, a citizen of France might use a German firm for basic banking services, borrow a home mortgage from an Italian institution, buy auto insurance from a Dutch enterprise, and keep her savings in mutual funds managed by a British company. Similarly, an Italian firm might raise capital from investors across Europe, using a German firm as its lead underwriter to issue stock for sale through stock exchanges in London and Frankfurt.

One main benefit of a single market, according to its advocates, would be greater competition for financial services, which would give consumers more choices, lower prices, and require financial service firms in the EU to become more efficient, thereby increasing their global competitiveness. Another major benefit would be the creation of a single European capital market. The increased liquidity of a larger capital market would make it easier for firms to borrow funds, lowering their cost of capital (the price of money) and stimulating business investment in Europe, which would create more jobs. A European Commission study suggested that the creation of a single market in financial services would increase the EU's gross domestic product by 1.1 percent a year, creating an additional 130 billion euros (€) in wealth over a decade. Total business investment would increase by 6 percent annually in the long run, private consumption by 0.8 percent, and total employment by 0.5 percent a year.

Creating a single market has been anything but easy. The financial markets of different EU member states have historically been segmented from each other, and each has its own regulatory framework. In the past, EU financial services firms rarely did business across national borders because of a host of different national regulations with regard to taxation, oversight, accounting information, cross-border takeovers, and the like, all of which had to be harmonized. To complicate matters, longstanding cultural and linguistic barriers complicated the move toward a single market. While in theory an Italian might benefit by being able to purchase homeowners' insurance from a British company, in practice he might be predisposed to purchase it from a local enterprise, even if the price were higher.

By 2011 the EU had made significant progress. More than 40 measures designed to create a single market in financial services had become EU law and others were in the pipeline. The new rules embraced issues as diverse as the conduct of business by investment firms, stock exchanges, and banks; disclosure standards for listing companies on public exchanges; and the harmonization of accounting standards across nations. However, there had also been some significant setbacks. Most notably, legislation designed to make it easier for firms to make hostile cross-border acquisitions was defeated, primarily due to opposition from German members of the European Parliament, making it more difficult for financial service firms to build pan-European operations. In addition, national governments have still reserved the right to block even friendly cross-border mergers between financial service firms. For example, Italian banking law still requires the governor of the Bank of Italy to give permission to any foreign enterprise that wishes to purchase more than 5 percent of an Italian bank—and no foreigners have yet to acquire a majority position in an Italian bank, primarily, say critics, due to nationalistic concerns on the part of the Italians.

The critical issue now is enforcement of the rules that have been put in place. Some believe that it will be at least another decade before the benefits of the new regulations become apparent. In the meantime, the changes may impose significant costs on financial institutions as they attempt to deal with the new raft of regulations.[16]

national markets for auctioning off broadcast rights. Another example is given in the accompanying Country Focus, which describes the slow progress toward establishing a fully functioning single market for financial services in the EU. Thus, although the EU is undoubtedly moving toward a single marketplace, established legal, cultural, and language differences between nations mean that implementation has been uneven.

THE ESTABLISHMENT OF THE EURO

In December 1991, EC members signed a treaty (the **Maastricht Treaty**) that committed them to adopting a common currency by January 1, 1999.[17] The euro is now used by 17 of the 27 member states of the European Union; these 17 states are members of what is often referred to as the euro zone. It encompasses 330 million EU citizens and includes the powerful economies of Germany and France. Many of the countries that joined the EU on May 1, 2004, and the two that joined in 2007, will adopt the euro when they fulfill certain economic criteria—a high degree of price stability, a sound fiscal situation, stable exchange rates, and converged long-term interest rates. The current members had to meet the same criteria.

Establishment of the euro has rightly been described as an amazing political feat with few historical precedents. Establishing the euro required participating national governments not only to give up their own currencies, but also to give up control over monetary policy. Governments do not routinely sacrifice national sovereignty for the greater good, indicating the importance that the Europeans attach to the euro. By adopting the euro, the EU has created the second most widely traded currency in the world after that of the U.S. dollar. Some believe that ultimately the euro could come to rival the dollar as the most important currency in the world.

Three long-term EU members, Great Britain, Denmark, and Sweden, are still sitting on the sidelines. The countries agreeing to the euro locked their exchange rates against each other January 1, 1999. Euro notes and coins were not actually issued until January 1, 2002. In the interim, national currencies circulated in each of the 12 countries. However, in each participating state, the national currency stood for a defined amount of euros. After January 1, 2002, euro notes and coins were issued and the national currencies were taken out of circulation. By mid-2002, all prices and routine economic transactions within the euro zone were in euros.

Benefits of the Euro

Europeans decided to establish a single currency in the EU for a number of reasons. First, they believe that businesses and individuals will realize significant savings from having to handle one currency, rather than many. These savings come from lower foreign exchange and hedging costs. For example, people going from Germany to France no longer have to pay a commission to a bank to change German deutsche marks into French francs. Instead, they are able to use euros. According to the European Commission, such savings amount to 0.5 percent of the European Union's GDP, or about $80 billion a year.

Second, and perhaps more importantly, the adoption of a common currency makes it easier to compare prices across Europe. This has been increasing competition because it has become easier for consumers to shop around. For example, if a German finds that cars sell for less in France than Germany, he may be tempted to purchase from a French car dealer rather than his local car dealer. Alternatively, traders may engage in arbitrage to exploit such price differentials, buying cars in France and reselling them in Germany. The only way that German car dealers will be able to hold on to business in the face of such competitive pressures will be to reduce the prices they charge for cars. As a consequence of such pressures, the introduction of a common currency has led to lower prices, which translates into substantial gains for European consumers.

Third, faced with lower prices, European producers have been forced to look for ways to reduce their production costs to maintain their profit margins. The introduction of a common currency, by increasing competition, has produced long-run gains in the economic efficiency of European companies.

Fourth, the introduction of a common currency has given a boost to the development of a highly liquid pan-European capital market. Over time, the development of such a capital market should lower the cost of capital and lead to an increase in both the level of investment and the efficiency with which investment funds are allocated. This could be especially helpful to smaller companies that have historically had difficulty borrowing

money from domestic banks. For example, the capital market of Portugal is very small and illiquid, which makes it extremely difficult for bright Portuguese entrepreneurs with a good idea to borrow money at a reasonable price. However, in theory, such companies can now tap a much more liquid pan-European capital market.

Finally, the development of a pan-European, euro-denominated capital market will increase the range of investment options open to both individuals and institutions. For example, it will now be much easier for individuals and institutions based in, let's say, Holland to invest in Italian or French companies. This will enable European investors to better diversify their risk, which again lowers the cost of capital, and should also increase the efficiency with which capital resources are allocated.[18]

Costs of the Euro

The drawback, for some, of a single currency is that national authorities have lost control over monetary policy. Thus, it is crucial to ensure that the EU's monetary policy is well managed. The Maastricht Treaty called for establishment of the independent European Central Bank (ECB), similar in some respects to the U.S. Federal Reserve, with a clear mandate to manage monetary policy so as to ensure price stability. The ECB, based in Frankfurt, is meant to be independent from political pressure—although critics question this. Among other things, the ECB sets interest rates and determines monetary policy across the euro zone.

The implied loss of national sovereignty to the ECB underlies the decision by Great Britain, Denmark, and Sweden to stay out of the euro zone for now. Many in these countries are suspicious of the ECB's ability to remain free from political pressure and to keep inflation under tight control.

In theory, the design of the ECB should ensure that it remains free of political pressure. The ECB is modeled on the German Bundesbank, which historically has been the most independent and successful central bank in Europe. The Maastricht Treaty prohibits the ECB from taking orders from politicians. The executive board of the bank, which consists of a president, vice president, and four other members, carries out policy by issuing instructions to national central banks. The policy itself is determined by the governing council, which consists of the executive board plus the central bank governors from the 17 euro zone countries. The governing council votes on interest rate changes. Members of the executive board are appointed for eight-year nonrenewable terms, insulating them from political pressures to get reappointed. Nevertheless, the jury is still out on the issue of the ECB's independence, and it will take some time for the bank to establish its credentials.

According to critics, another drawback of the euro is that the EU is not what economists would call an optimal currency area. In an **optimal currency area**, similarities in the underlying structure of economic activity make it feasible to adopt a single currency and use a single exchange rate as an instrument of macroeconomic policy. Many of the European economies in the euro zone, however, are very dissimilar. For example, Finland and Portugal have different wage rates, tax regimes, and business cycles, and they may react very differently to external economic shocks. A change in the euro exchange rate that helps Finland may hurt Portugal. Obviously, such differences complicate macroeconomic policy. For example, when euro economies are not growing in unison, a common monetary policy may mean that interest rates are too high for depressed regions and too low for booming regions. It will be interesting to see how the EU copes with the strains caused by such divergent economic performance.

One way of dealing with such divergent effects within the euro zone might be for the EU to engage in fiscal transfers, taking money from prosperous regions and pumping it into depressed regions. Such a move, however, would open a political can of worms. Would the citizens of Germany forgo their "fair share" of EU funds to create jobs for underemployed Portuguese workers?

Some critics believe that the euro puts the economic cart before the political horse. In their view, a single currency should follow, not precede, political union. They argue

that the euro will unleash enormous pressures for tax harmonization and fiscal transfers from the center, both policies that cannot be pursued without the appropriate political structure. The most apocalyptic vision that flows from these negative views is that far from stimulating economic growth, as its advocates claim, the euro will lead to lower economic growth and higher inflation within Europe. To quote one critic:

> Imposing a single exchange rate and an inflexible exchange rate on countries that are characterized by different economic shocks, inflexible wages, low labor mobility, and separate national fiscal systems without significant cross-border fiscal transfers will raise the overall level of cyclical unemployment among EMU members. The shift from national monetary policies dominated by the (German) Bundesbank within the European Monetary System to a European Central Bank governed by majority voting with a politically determined exchange rate policy will almost certainly raise the average future rate of inflation.[19]

The Experience to Date

Since its establishment January 1, 1999, the euro has had a volatile trading history against the world's major currency, the U.S. dollar. After starting life in 1999 at €1 = $1.17, the euro steadily fell until it reached a low of €1 = $0.83 cents in October 2000, leading critics to claim the euro was a failure. A major reason for the fall in the euro's value was that international investors were investing money in booming U.S. stocks and bonds and taking money out of Europe to finance this investment. In other words, they were selling euros to buy dollars so that they could invest in dollar-denominated assets. This increased the demand for dollars and decreased the demand for the euro, driving the value of the euro down.

The fortunes of the euro began improving in late 2001 when the dollar weakened; the currency stood at a robust all-time high of €1 = $1.54 in early March 2008. One reason for the rise in the value of the euro was that the flow of capital into the United States had stalled as the U.S. financial markets fell.[20] Many investors were now taking money out of the United States, selling dollar-denominated assets such as U.S. stocks and bonds, and purchasing euro-denominated assets. Falling demand for U.S. dollars and rising demand for euros translated into a fall in the value of the dollar against the euro. Furthermore, in a vote of confidence in both the euro and the ability of the ECB to manage monetary policy within the euro zone, many foreign central banks added more euros to their supply of foreign currencies. In the first three years of its life, the euro never reached the 13 percent of global reserves made up by the deutsche mark and other former euro zone currencies. The euro didn't jump that hurdle until early 2002, but by 2004 it made up 20 percent of global reserves. Currency specialists expected the growing U.S. current account deficit, which reached 7 percent of GDP in 2005, to drive the dollar down further, and the euro still higher over the next two to four years.[21] In 2007 this started to occur, with the euro appreciating steadily against the dollar from 2005 until early 2008. Since then the euro has weakened somewhat, reflecting concerns over slow economic growth and growing budget deficits among several EU member states, particularly Greece, Portugal, and Spain (see the accompanying Country Focus for more details). Nevertheless, in early 2011 the exchange rate, which stood at €1 = $1.36, was still strong compared to the exchange rate in the early 2000s. While the strong euro has been a source of pride for Europeans, it does make it harder for euro zone exporters to sell their goods abroad.

ENLARGEMENT OF THE EUROPEAN UNION

A major issue facing the EU over the past few years has been that of enlargement. Enlargement of the EU into Eastern Europe has been a possibility since the collapse of communism at the end of the 1980s, and by the end of the 1990s, 13 countries had applied to become EU members. To qualify for EU membership the applicants had to privatize state assets, deregulate markets, restructure industries, and tame inflation. They also had

COUNTRY FOCUS

Sovereign Debt Crisis in the Euro Zone

When the euro was established, some critics worried that free-spending countries in the euro zone (such as Italy) might borrow excessively, running up large public-sector deficits that they could not finance. This would then rock the value of the euro, requiring their more sober brethren, such as Germany or France, to step in and bail out the profligate nation. In 2010 this worry was fast becoming a reality as a financial crisis in Greece rocked the value of the euro.

The financial crisis had its roots in a decade of free spending by the Greek government, which ran up a high level of debt to finance extensive spending in the public sector. Much of the spending increase could be characterized as an attempt by the government to buy off powerful interest groups in Greek society, from teachers and farmers to public-sector employees, rewarding them with high pay and extensive benefits. To make matters worse, the government misled the international community about the level of its indebtedness. In October 2009 a new government took power and quickly announced that the 2009 public-sector deficit, which had been projected to be around 5 percent, would actually be 12.7 percent. The previous government had apparently been cooking the books.

This shattered any faith that international investors might have in the Greek economy. Interest rates on Greek government debt soared to 7.1 percent, about 4 percentage points higher than the rate on German bonds. Two of the three international rating agencies also cut their ratings on Greek bonds and warned that further downgrades were likely. The main concern now was that the Greek government might not be able to refinance some €20 billion of debt that matured in April or May of 2010. A further concern was that the Greek government might lack the political willpower to make the large cuts in public spending necessary to bring down the deficit and restore investor confidence.

Nor was Greece alone in having large public-sector deficits. Three other euro zone countries—Spain, Portugal, and Ireland—also all had large debt loads, and interest rates on their bonds also surged as investors sold out. This raised the specter of financial contagion, with large-scale defaults among the weaker members of the euro zone. If this did occur, the EU and IMF would most certainly have to step in and rescue the troubled nations. With this possibility, once considered very remote, investors started to move money out of euros, and the value of the euro started to fall on the foreign exchange market.

Recognizing that the unthinkable might happen, and that without external help Greece might default on its government debt, pushing the EU and the euro into a major crisis, in May 2010 the euro zone countries, led by Germany, along with the IMF agreed to lend Greece up to €110 billion. These loans are sufficient to cover Greece's financing needs for three years. In exchange, the Greek government agreed to implement a series of strict austerity measures. These included tax increases, major cuts in public-sector pay, reductions in benefits enjoyed by public-sector employees (for example, the retirement age was increased to 65 from 61 and limits were placed on pensions), and reductions in the number of public-sector enterprises from 6,000 to 2,000. This show of support helped to stabilize the euro, which after hitting a low of €1 = $1.196 in June 2010 climbed back to €1 = $1.36 by early 2011.[22]

to enshrine complex EU laws into their own systems, establish stable democratic governments, and respect human rights.[23] In December 2002, the EU formally agreed to accept the applications of 10 countries, and they joined May 1, 2004. The new members include the Baltic countries, the Czech Republic, and the larger nations of Hungary and Poland. The only new members not in Eastern Europe are the Mediterranean island nations of Malta and Cyprus. Their inclusion in the EU expanded the union to 25 states, stretching from the Atlantic to the borders of Russia; added 23 percent to the landmass of the EU; brought 75 million new citizens into the EU, building an EU with a population of 450 million people; and created a single continental economy with a GDP of close to €11 trillion. In 2007, Bulgaria and Romania joined, bringing total membership to 27 nations.

The new members were not able to adopt the euro until at least 2007 (and 2010 in the case of the latest entrants), and free movement of labor between the new and existing members was prohibited until then. Consistent with theories of free trade, the enlargement should create added benefits for all members. However, given the small size of the Eastern European economies (together they amount to only 5 percent of the GDP of current EU members), the initial impact will probably be small. The biggest notable change might be in the EU bureaucracy and decision-making processes, where budget negotiations among 27 nations are bound to prove more problematic than negotiations among 15 nations.

Left standing at the door is Turkey. Turkey, which has long lobbied to join the union, presents the EU with some difficult issues. The country has had a customs union with the EU since 1995, and about half of its international trade is already with the EU. However, full membership has been denied because of concerns over human rights issues (particularly Turkish policies toward its Kurdish minority). In addition, some on the Turk side suspect the EU is not eager to let a primarily Muslim nation of 66 million people, which has one foot in Asia, join the EU. The EU formally indicated in December 2002 that it would allow the Turkish application to proceed with no further delay in December 2004 if the country improved its human rights record to the satisfaction of the EU. In December 2004 the EU agreed to allow Turkey to start accession talks in October 2005, but those talks are not moving along rapidly, and the nation will not join until 2013, if at all.

Regional Economic Integration in the Americas LO4

No other attempt at regional economic integration comes close to the EU in its boldness or its potential implications for the world economy, but regional economic integration is on the rise in the Americas. The most significant attempt is the North American Free Trade Agreement. In addition to NAFTA, several other trade blocs are in the offing in the Americas (see Map 9.2), the most significant of which appear to be the Andean Community and Mercosur. Also, negotiations are under way to establish a hemispherewide Free Trade Area of the Americas (FTAA), although currently they seem to be stalled.

THE NORTH AMERICAN FREE TRADE AGREEMENT

The governments of the United States and Canada in 1988 agreed to enter into a free trade agreement, which took effect January 1, 1989. The goal of the agreement was to eliminate all tariffs on bilateral trade between Canada and the United States by 1998. This was followed in 1991 by talks among the United States, Canada, and Mexico aimed at establishing a **North American Free Trade Agreement** for the three countries. The talks concluded in August 1992 with an agreement in principle, and the following year the agreement was ratified by the governments of all three countries. The agreement became law January 1, 1994.[24]

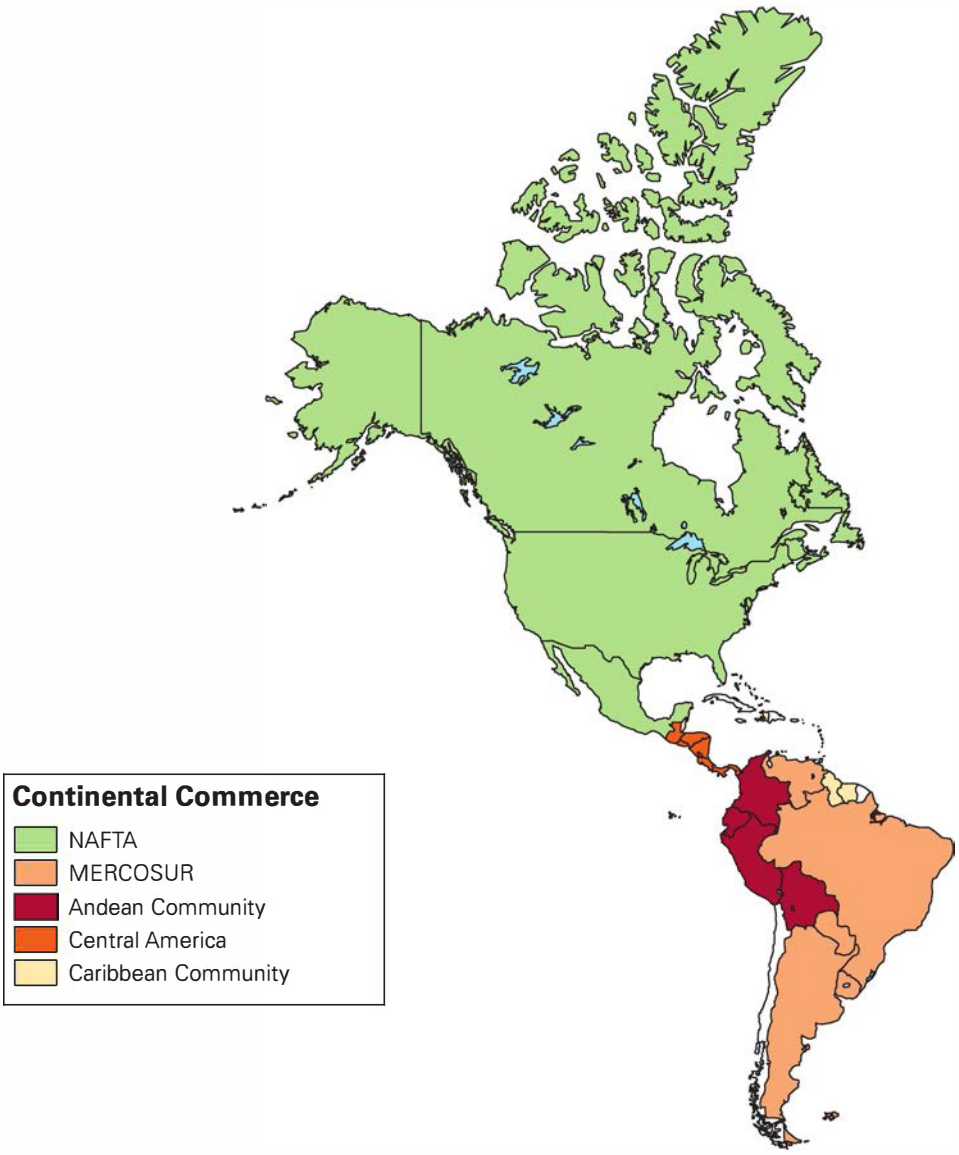
NAFTA'S Contents

The contents of NAFTA include the following:

- Abolition by 2004 of tariffs on 99 percent of the goods traded between Mexico, Canada, and the United States.
- Removal of most barriers on the cross-border flow of services, allowing financial institutions, for example, unrestricted access to the Mexican market by 2000.
- Protection of intellectual property rights.
- Removal of most restrictions on foreign direct investment between the three member countries, although special treatment (protection) will be given to Mexican energy and railway industries, American airline and radio communications industries, and Canadian culture.

MAP 9.2

Economic Integration in the Americas



- Application of national environmental standards, provided such standards have a scientific basis. Lowering of standards to lure investment is described as being inappropriate.
- Establishment of two commissions with the power to impose fines and remove trade privileges when environmental standards or legislation involving health and safety, minimum wages, or child labor is ignored.

The Case for NAFTA

Proponents of NAFTA have argued that the free trade area should be viewed as an opportunity to create an enlarged and more efficient productive base for the entire region. Advocates acknowledge that one effect of NAFTA would be that some U.S. and Canadian firms would move production to Mexico to take advantage of lower labor costs. (In 2004, the average hourly labor cost in Mexico was still one-tenth of that in the United States and Canada.) Movement of production to Mexico, they argued, was most likely to occur in low-skilled, labor-intensive manufacturing industries where Mexico might have a comparative advantage. Advocates of NAFTA argued that many would benefit from such a trend. Mexico would benefit from much-needed inward investment and employment. The United States and Canada would benefit because the increased incomes of

the Mexicans would allow them to import more U.S. and Canadian goods, thereby increasing demand and making up for the jobs lost in industries that moved production to Mexico. U.S. and Canadian consumers would benefit from the lower prices of products made in Mexico. In addition, the international competitiveness of U.S. and Canadian firms that moved production to Mexico to take advantage of lower labor costs would be enhanced, enabling them to better compete with Asian and European rivals.

The Case against NAFTA

Those who opposed NAFTA claimed that ratification would be followed by a mass exodus of jobs from the United States and Canada into Mexico as employers sought to profit from Mexico's lower wages and less strict environmental and labor laws. According to one extreme opponent, Ross Perot, up to 5.9 million U.S. jobs would be lost to Mexico after NAFTA in what he famously characterized as a "giant sucking sound." Most economists, however, dismissed these numbers as being absurd and alarmist. They argued that Mexico would have to run a bilateral trade surplus with the United States of close to $300 billion for job loss on such a scale to occur—and $300 billion was the size of Mexico's GDP. In other words, such a scenario seemed implausible.

More sober estimates of the impact of NAFTA ranged from a net creation of 170,000 jobs in the United States (due to increased Mexican demand for U.S. goods and services) and an increase of $15 billion per year to the joint U.S. and Mexican GDP, to a net loss of 490,000 U.S. jobs. To put these numbers in perspective, employment in the U.S. economy was predicted to grow by 18 million from 1993 to 2003. As most economists repeatedly stressed, NAFTA would have a small impact on both Canada and the United States. It could hardly be any other way, since the Mexican economy was only 5 percent of the size of the U.S. economy. Signing NAFTA required the largest leap of economic faith from Mexico rather than Canada or the United States. Falling trade barriers would expose Mexican firms to highly efficient U.S. and Canadian competitors that, when compared to the average Mexican firm, had far greater capital resources, access to highly educated and skilled workforces, and much greater technological sophistication. The short-run outcome was likely to be painful economic restructuring and unemployment in Mexico. But advocates of NAFTA claimed there would be long-run dynamic gains in the efficiency of Mexican firms as they adjusted to the rigors of a more competitive marketplace. To the extent that this occurred, they argued, Mexico's economic growth rate would accelerate, and Mexico might become a major market for Canadian and U.S. firms.[25]

Environmentalists also voiced concerns about NAFTA. They pointed to the sludge in the Rio Grande and the smog in the air over Mexico City and warned that Mexico could degrade clean air and toxic waste standards across the continent. They pointed out that the lower Rio Grande was the most polluted river in the United States, and that with NAFTA, chemical waste and sewage would increase along its course from El Paso, Texas, to the Gulf of Mexico.

There was also opposition in Mexico to NAFTA from those who feared a loss of national sovereignty. Mexican critics argued that their country would be dominated by U.S. firms that would not really contribute to Mexico's economic growth, but instead would use Mexico as a low-cost assembly site, while keeping their high-paying, high-skilled jobs north of the border.

NAFTA: The Results

Studies of NAFTA's impact suggest its initial effects were at best muted, and both advocates and detractors may have been guilty of exaggeration.[26] On average, studies indicate that NAFTA's overall impact has been small but positive.[27] From 1993 to 2005, trade between NAFTA's partners grew by 250 percent.[28] Canada and Mexico are now the No. 1 and 2 trade partners of the United States, suggesting the economies of the three NAFTA nations have become more closely integrated. In 1990, U.S. trade with Canada and Mexico accounted for about a quarter of total U.S. trade. By 2005, the

figure was close to one-third. Canada's trade with its NAFTA partners increased from about 70 percent to more than 80 percent of all Canadian foreign trade between 1993 and 2005, while Mexico's trade with NAFTA increased from 66 percent to 80 percent over the same period. All three countries also experienced strong productivity growth over this period. In Mexico, labor productivity has increased by 50 percent since 1993, and the passage of NAFTA may have contributed to this. However, estimates suggest that employment effects of NAFTA have been small. The most pessimistic estimates suggest the United States lost 110,000 jobs per year due to NAFTA between 1994 and 2000—and many economists dispute this figure—which is tiny compared to the more than 2 million jobs a year created in the United States during the same period.

Perhaps the most significant impact of NAFTA has not been economic, but political. Many observers credit NAFTA with helping to create the background for increased political stability in Mexico. For most of the post NAFTA period, Mexico has been viewed as a stable democratic nation with a steadily growing economy, something that is beneficial to the United States, which shares a 2,000-mile border with the country.[29] However, recent events have cast a cloud over Mexico's future. In late 2006 the newly elected Mexican President Felipe Calderon initiated a crackdown on Mexico's increasingly powerful drug cartels (whose main business has been the illegal trafficking of drugs across the border into the United States). Calderon sent 6,500 troops into the Mexican state of Michoacan to end escalating drug violence there. The cartels responded by escalating their own violence, and the country is now gripped in what amounts to an all-out war. Fueled by the lucrative business of selling drugs to the United States and armed with guns purchased in the United States, the cartels have been fighting each other and the Mexican authorities in an increasingly brutal conflict that claimed 9,000 lives in 2009 and another 15,000 in 2010, and which many fear threatens to spill into the United States.[30]

Enlargement

One issue confronting NAFTA is that of enlargement. A number of other Latin American countries have indicated their desire to eventually join NAFTA. The governments of both Canada and the United States are adopting a wait-and-see attitude with regard to most countries. Getting NAFTA approved was a bruising political experience, and neither government is eager to repeat the process soon. Nevertheless, the Canadian, Mexican, and U.S. governments began talks in 1995 regarding Chile's possible entry into NAFTA. As of 2011, however, these talks had yielded little progress, partly because of political opposition in the U.S. Congress to expanding NAFTA. In December 2002, however, the United States and Chile did sign a bilateral free trade pact.

THE ANDEAN COMMUNITY

Bolivia, Chile, Ecuador, Colombia, and Peru signed an agreement in 1969 to create the Andean Pact. The **Andean Pact** was largely based on the EU model, but was far less successful at achieving its stated goals. The integration steps begun in 1969 included an internal tariff reduction program, a common external tariff, a transportation policy, a common industrial policy, and special concessions for the smallest members, Bolivia and Ecuador.

By the mid-1980s, the Andean Pact had all but collapsed and had failed to achieve any of its stated objectives. There was no tariff-free trade between member countries, no common external tariff, and no harmonization of economic policies. Political and economic problems seem to have hindered cooperation between member countries. The countries of the Andean Pact have had to deal with low economic growth, hyperinflation, high unemployment, political unrest, and crushing debt burdens. In addition, the dominant political ideology in many of the Andean countries during this period tended toward the radical/socialist end of the political spectrum. Since such an ideology is hostile to the free market economic principles on which the Andean Pact was based, progress toward closer integration could not be expected.

The tide began to turn in the late 1980s when, after years of economic decline, the governments of Latin America began to adopt free market economic policies. In 1990, the heads of the five current members of the Andean Community—Bolivia, Ecuador, Peru, Colombia, and Venezuela—met in the Galápagos Islands. The resulting Galápagos Declaration effectively relaunched the Andean Pact, which was renamed the Andean Community in 1997. The declaration's objectives included the establishment of a free trade area by 1992, a customs union by 1994, and a common market by 1995. This last milestone has not been reached. A customs union was implemented in 1995, although until 2003 Peru opted out and Bolivia received preferential treatment. The Andean Community now operates as a customs union. In December 2003, it signed an agreement with Mercosur to restart stalled negotiations on the creation of a free trade area between the two trading blocs. Those negotiations are proceeding at a slow pace. In late 2006, Venezuela withdrew from the Andean Community as part of that country's attempts to join Mercosur.

MERCOSUR

Mercosur originated in 1988 as a free trade pact between Brazil and Argentina. The modest reductions in tariffs and quotas accompanying this pact reportedly helped bring about an 80 percent increase in trade between the two countries in the late 1980s.[31] This success encouraged the expansion of the pact in March 1990 to include Paraguay and Uruguay. In 2005, the pact was further expanded when Venezuela joined Mercosur, although it may take years for Venezuela to become fully integrated into the pact.

The initial aim of Mercosur was to establish a full free trade area by the end of 1994 and a common market sometime thereafter. In December 1995, Mercosur's members agreed to a five-year program under which they hoped to perfect their free trade area and move toward a full customs union—something that has yet to be achieved.[32] For its first eight years or so, Mercosur seemed to be making a positive contribution to the economic growth rates of its member states. Trade between the four core members quadrupled between 1990 and 1998. The combined GDP of the four member states grew at an annual average rate of 3.5 percent between 1990 and 1996, a performance that is significantly better than the four attained during the 1980s.[33]

However, Mercosur had its critics, including Alexander Yeats, a senior economist at the World Bank, who wrote a stinging critique.[34] According to Yeats, the trade diversion effects of Mercosur outweigh its trade creation effects. Yeats pointed out that the fastest growing items in intra-Mercosur trade were cars, buses, agricultural equipment, and other capital-intensive goods that are produced relatively inefficiently in the four member countries. In other words, Mercosur countries, insulated from outside competition by tariffs that run as high as 70 percent of value on motor vehicles, are investing in factories that build products that are too expensive to sell to anyone but themselves. The result, according to Yeats, is that Mercosur countries might not be able to compete globally once the group's external trade barriers come down. In the meantime, capital is being drawn away from more efficient enterprises. In the near term, countries with more efficient manufacturing enterprises lose because Mercosur's external trade barriers keep them out of the market.

Mercosur hit a significant roadblock in 1998, when its member states slipped into recession and intrabloc trade slumped. Trade fell further in 1999 following a financial crisis in Brazil that led to the devaluation of the Brazilian real, which immediately made the goods of other Mercosur members 40 percent more expensive in Brazil, their largest export market. At this point, progress toward establishing a full customs union all but stopped. Things deteriorated further in 2001 when Argentina, beset by economic stresses, suggested the customs union be temporarily suspended. Argentina wanted to suspend Mercosur's tariff so that it could abolish duties on imports of capital equipment, while raising those on consumer goods to 35 percent (Mercosur had established a 14 percent import tariff on both sets of goods). Brazil agreed to this request, effectively halting Mercosur's

quest to become a fully functioning customs union.[35] Hope for a revival arose in 2003 when new Brazilian President Lula da Silva announced his support for a revitalized and expanded Mercosur modeled after the EU with a larger membership, a common currency, and a democratically elected Mercosur parliament.[36] As of 2011, however, little progress had been made in moving Mercosur down that road, and critics believed the customs union was, if anything, becoming more imperfect over time.[37]

CENTRAL AMERICAN COMMON MARKET, CAFTA, AND CARICOM

Two other trade pacts in the Americas have not made much progress. In the early 1960s, Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua attempted to set up a **Central American Common Market**. It collapsed in 1969 when war broke out between Honduras and El Salvador after a riot at a soccer match between teams from the two countries. Since then the member countries have made some progress toward reviving their agreement (the five founding members were joined by the Dominican Republic). The proposed common market was given a boost in 2003 when the United States signaled its intention to enter into bilateral free trade negotiations with the group. These cumulated in a 2005 agreement to establish a free trade agreement between the six countries and the United States. Known as the **Central America Free Trade Agreement**, or CAFTA, the aim is to lower trade barriers between the United States and the six countries for most goods and services.

A customs union was to have been created in 1991 between the English-speaking Caribbean countries under the auspices of the Caribbean Community. Referred to as **CARICOM**, it was established in 1973. However, it repeatedly failed to progress toward economic integration. A formal commitment to economic and monetary union was adopted by CARICOM's member states in 1984, but since then little progress has been made. In October 1991, the CARICOM governments failed, for the third consecutive time, to meet a deadline for establishing a common external tariff. Despite this, CARICOM expanded to 15 members by 2005. In early 2006, six CARICOM members established the **Caribbean Single Market and Economy** (CSME). Modeled on the EU's single market, CSME's goal is to lower trade barriers and harmonize macroeconomic and monetary policy between member states.[38]

FREE TRADE AREA OF THE AMERICAS

At a hemispherewide Summit of the Americas in December 1994, a Free Trade Area of the Americas (FTAA) was proposed. It took more than three years for the talks to start, but in April 1998, 34 heads of state traveled to Santiago, Chile, for the second Summit of the Americas where they formally inaugurated talks to establish an FTAA by January 1, 2005—something that didn't occur. The continuing talks have addressed a wide range of economic, political, and environmental issues related to cross-border trade and investment. Although both the United States and Brazil were early advocates of the FTAA, support from both countries seems to be mixed at this point. Because the United States and Brazil have the largest economies in North and South America, respectively, strong U.S. and Brazilian support is a precondition for establishment of the free trade area.

The major stumbling blocks so far have been twofold. First, the United States wants its southern neighbors to agree to tougher enforcement of intellectual property rights and lower manufacturing tariffs, which they do not seem to be eager to embrace. Second, Brazil and Argentina want the United States to reduce its subsidies to U.S. agricultural producers and scrap tariffs on agricultural imports, which the U.S. government does not seem inclined to do. For progress to be made, most observers agree that the United States and Brazil have to first reach an agreement on these crucial issues.[39] If the FTAA is

eventually established, it will have major implications for cross-border trade and investment flows within the hemisphere. The FTAA would open a free trade umbrella over 850 million people who accounted for some $18 trillion in GDP in 2008.

Currently, however, FTAA is very much a work in progress, and the progress has been slow. The most recent attempt to get talks going again, in November 2005 at a summit of 34 heads of state from North and South America, failed when opponents, led by Venezuela's populist President Hugo Chavez, blocked efforts by the Bush administration to set an agenda for further talks on FTAA. In voicing his opposition, Chavez condemned the U.S. free trade model as a "perversion" that would unduly benefit the United States to the detriment of poor people in Latin America whom Chavez claims have not benefited from free trade details.[40] Such views make it unlikely that there will be much progress on establishing a FTAA in the near term.

Regional Economic Integration Elsewhere LO4

Numerous attempts at regional economic integration have been tried throughout Asia and Africa. However, few exist in anything other than name. Perhaps the most significant is the Association of Southeast Asian Nations (ASEAN). In addition, the Asia-Pacific Economic Cooperation (APEC) forum has recently emerged as the seed of a potential free trade region.

ASSOCIATION OF SOUTHEAST ASIAN NATIONS

Formed in 1967, the **Association of Southeast Asian Nations (ASEAN)** includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam. Laos, Myanmar, Vietnam, and Cambodia have all joined recently, creating a regional grouping of 500 million people with a combined GDP of some $740 billion (see Map 9.3). The basic objective of ASEAN is to foster freer trade between member countries and to achieve cooperation in their industrial policies. Progress so far has been limited, however.

Until recently only 5 percent of intra-ASEAN trade consisted of goods whose tariffs had been reduced through an ASEAN preferential trade arrangement. This may be changing. In 2003, an ASEAN Free Trade Area (AFTA) between the six original members of ASEAN came into full effect. The AFTA has cut tariffs on manufacturing and agricultural products to less than 5 percent. However, there are some significant exceptions to this tariff reduction. Malaysia, for example, refused to bring down tariffs on imported cars until 2005 and then agreed to lower the tariff only to 20 percent, not the 5 percent called for under the AFTA. Malaysia wanted to protect Proton, an inefficient local carmaker, from foreign competition. Similarly, the Philippines has refused to lower tariff rates on petrochemicals, and rice, the largest agricultural product in the region, will remain subject to higher tariff rates until at least 2020.[41]

Notwithstanding such issues, ASEAN and AFTA are at least progressing toward establishing a free trade zone. Vietnam joined the AFTA in 2006, Laos and Myanmar in 2008, and Cambodia in 2010. The goal was to reduce import tariffs among the six original members to zero by 2010, and to do so by 2015 for the newer members (although important exceptions to that goal, such as tariffs on rice, will persist).

ASEAN also recently signed a free trade agreement with China that removes tariffs on 90 percent of traded goods. This went into effect January 1, 2010. Trade between China and ASEAN members more than tripled during the first decade of the twenty-first century, and this agreement should spur further growth.[42]

ASIA-PACIFIC ECONOMIC COOPERATION

Asia-Pacific Economic Cooperation (APEC) was founded in 1990 at the suggestion of Australia. APEC currently has 21 member states, including such economic powerhouses



MAP 9.3

ASEAN Countries

Source: www.aseansec.org.

as the United States, Japan, and China (see Map 9.4). Collectively, the member states account for about 55 percent of the world's GNP, 49 percent of world trade, and much of the growth in the world economy. The stated aim of APEC is to increase multilateral cooperation in view of the economic rise of the Pacific nations and the growing interdependence within the region. U.S. support for APEC was also based on the belief that it might prove a viable strategy for heading off any moves to create Asian groupings from which it would be excluded.

Interest in APEC was heightened considerably in November 1993 when the heads of APEC member states met for the first time at a two-day conference in Seattle. Debate before the meeting speculated on the likely future role of APEC. One view was that APEC should commit itself to the ultimate formation of a free trade area. Such a move would transform the Pacific Rim from a geographical expression into the world's largest free trade area. Another view was that APEC would produce no more than hot air and lots of photo opportunities for the leaders involved. As it turned out, the APEC meeting



MAP 9.4

APEC Members

Source: From www.apec.org. Reprinted with permission.

produced little more than some vague commitments from member states to work together for greater economic integration and a general lowering of trade barriers. However, member states did not rule out the possibility of closer economic cooperation in the future.[43]

The heads of state have met again on a number of occasions. At a 1997 meeting, member states formally endorsed proposals designed to remove trade barriers in 15 sectors, ranging from fish to toys. However, the vague plan committed APEC to doing no more than holding further talks, which is all that has been accomplished to date. Commenting on the vagueness of APEC pronouncements, the influential Brookings Institution, a U.S.-based economic policy institution, noted APEC "is in grave danger of shrinking into irrelevance as a serious forum." Despite the slow progress, APEC is worth watching. If it eventually does transform itself into a free trade area, it will probably be the world's largest.[44]

REGIONAL TRADE BLOCS IN AFRICA

African countries have been experimenting with regional trade blocs for half a century. There are now nine trade blocs on the African continent. Many countries are members of more than one group. Although the number of trade groups is impressive, progress toward the establishment of meaningful trade blocs has been slow.

Many of these groups have been dormant for years. Significant political turmoil in several African nations has persistently impeded any meaningful progress. Also, deep

suspicion of free trade exists in several African countries. The argument most frequently heard is that because these countries have less developed and less diversified economies, they need to be "protected" by tariff barriers from unfair foreign competition. Given the prevalence of this argument, it has been hard to establish free trade areas or customs unions.

The most recent attempt to reenergize the free trade movement in Africa occurred in early 2001, when Kenya, Uganda, and Tanzania, member states of the East African Community (EAC), committed themselves to relaunching their bloc, 24 years after it collapsed. The three countries, with 80 million inhabitants, intend to establish a customs union, regional court, legislative assembly, and, eventually, a political federation.

Their program includes cooperation on immigration, road and telecommunication networks, investment, and capital markets. However, while local business leaders welcomed the relaunch as a positive step, they were critical of the EAC's failure in practice to make progress on free trade. At the EAC treaty's signing in November 1999, members gave themselves four years to negotiate a customs union, with a draft slated for the end of 2001. But that fell far short of earlier plans for an immediate free trade zone, shelved after Tanzania and Uganda, fearful of Kenyan competition, expressed concerns that the zone could create imbalances similar to those that contributed to the breakup of the first community.[45] Nevertheless, in 2005 the EAC did start to implement a customs union, although many tariffs remained in place until 2010. In 2007, Burundi and Rwanda joined the EAC.

IMPLICATIONS FOR MANAGERS

LO5



Currently the most significant developments in regional economic integration are occurring in the EU and NAFTA. Although some of the Latin American trade blocs, ASEAN, and the proposed FTAA may have economic significance in the future, the EU and NAFTA currently have more profound and immediate implications for business practice. Accordingly, in this section we will concentrate on the business implications of those two groups. Similar conclusions, however, could be drawn with regard to the creation of a single market anywhere in the world.

OPPORTUNITIES

The creation of a single market through regional economic integration offers significant opportunities because markets that were formerly protected from foreign competition are increasingly open. For example, in Europe before 1992 the large French and Italian markets were among the most protected. These markets are now much more open to foreign competition in the form of both exports and direct investment. Nonetheless, to fully exploit such opportunities, it may pay non-EU firms to set up EU subsidiaries. Many major U.S. firms have long had subsidiaries in Europe. Those that do not would be advised to consider establishing them now, lest they run the risk of being shut out of the EU by nontariff barriers.

Additional opportunities arise from the inherent lower costs of doing business in a single market—as opposed to 27 national markets in the case of the EU or 3 national markets in the case of NAFTA. Free movement of goods across borders, harmonized product standards, and simplified tax regimes make it possible for firms based in the EU and the NAFTA countries to realize potentially significant cost economies by centralizing production in those EU and NAFTA locations where the mix of factor costs and skills is

optimal. Rather than producing a product in each of the 27 EU countries or the 3 NAFTA countries, a firm may be able to serve the whole EU or North American market from a single location. This location must be chosen carefully, of course, with an eye on local factor costs and skills.

For example, in response to the changes created by EU after 1992, the St. Paul-based 3M Company consolidated its European manufacturing and distribution facilities to take advantage of economies of scale. Thus, a plant in Great Britain now produces 3M's printing products and a German factory its reflective traffic control materials for all of the EU. In each case, 3M chose a location for centralized production after carefully considering the likely production costs in alternative locations within the EU. The ultimate goal of 3M is to dispense with all national distinctions, directing R&D, manufacturing, distribution, and marketing for each product group from an EU headquarters.[46] Similarly, Unilever, one of Europe's largest companies, began rationalizing its production in advance of 1992 to attain scale economies. Unilever concentrated its production of dishwashing powder for the EU in one plant, bath soap in another, and so on.[47]

Even after the removal of barriers to trade and investment, enduring differences in culture and competitive practices often limit the ability of companies to realize cost economies by centralizing production in key locations and producing a standardized product for a single multiple-country market. Consider the case of Atag Holdings NV, a Dutch maker of kitchen appliances.[48] Atag thought it was well placed to benefit from the single market, but found it tough going. Atag's plant is just one mile from the German border and near the center of the EU's population. The company thought it could cater to both the "potato" and "spaghetti" belts—marketers' terms for consumers in Northern and Southern Europe—by producing two main product lines and selling these standardized "euro-products" to "euro-consumers." The main benefit of doing so is the economy of scale derived from mass production of a standardized range of products. Atag quickly discovered that the "euro-consumer" was a myth. Consumer preferences vary much more across nations than Atag had thought. Consider ceramic cooktops; Atag planned to market just 2 varieties throughout the EU but has found it needs 11. Belgians, who cook in huge pots, require extra-large burners. Germans like oval pots and burners to fit. The French need small burners and very low temperatures for simmering sauces and broths. Germans like oven knobs on the top; the French want them on the front. Most Germans and French prefer black and white ranges; the British demand a range of colors including peach, pigeon blue, and mint green.

THREATS

Just as the emergence of single markets creates opportunities for business, it also presents a number of threats. For one thing, the business environment within each grouping will become more competitive. The lowering of barriers to trade and investment between countries is likely to lead to increased price competition throughout the EU and NAFTA. For example, before 1992 a Volkswagen Golf cost 55 percent more in Great Britain than in Denmark and 29 percent more in Ireland than in Greece.[49] Over time, such price differentials will vanish in a single market. This is a direct threat to any firm doing business in EU or NAFTA countries. To survive in the tougher single-market environment, firms must take advantage of the opportunities offered by the creation of a single market to rationalize their production and reduce their costs. Otherwise, they will be at a severe disadvantage.

A further threat to firms outside these trading blocs arises from the likely long-term improvement in the competitive position of many firms within the areas. This is particularly relevant in the EU, where many firms have historically been limited by a high-cost structure in their ability to compete globally with North American and Asian firms. The creation of a single market and the resulting increased competition in the EU is

beginning to produce serious attempts by many EU firms to reduce their cost structure by rationalizing production. This is transforming many EU companies into efficient global competitors. The message for non-EU businesses is that they need to prepare for the emergence of more capable European competitors by reducing their own cost structures.

Another threat to firms outside of trading areas is the threat of being shut out of the single market by the creation of a "trade fortress." The charge that regional economic integration might lead to a fortress mentality is most often leveled at the EU. Although the free trade philosophy underpinning the EU theoretically argues against the creation of any fortress in Europe, occasional signs indicate the EU may raise barriers to imports and investment in certain "politically sensitive" areas, such as autos. Non-EU firms might be well advised, therefore, to set up their own EU operations. This could also occur in the NAFTA countries, but it seems less likely.

Finally, the emerging role of the European Commission in competition policy suggests the EU is increasingly willing and able to intervene and impose conditions on companies proposing mergers and acquisitions. This is a threat insofar as it limits the ability of firms to pursue the corporate strategy of their choice. The commission may require significant concessions from businesses as a precondition for allowing proposed mergers and acquisitions to proceed. While this constrains the strategic options for firms, it should be remembered that in taking such action, the commission is trying to maintain the level of competition in Europe's single market, which should benefit consumers.

CHAPTER SUMMARY

This chapter pursued three main objectives: to examine the economic and political debate surrounding regional economic integration; to review the progress toward regional economic integration in Europe, the Americas, and elsewhere; and to distinguish the important implications of regional economic integration for the practice of international business. The chapter made the following points:

1. A number of levels of economic integration are possible in theory. In order of increasing integration, they include a free trade area, a customs union, a common market, an economic union, and full political union.
2. In a free trade area, barriers to trade between member countries are removed, but each country determines its own external trade policy. In a customs union, internal barriers to trade are removed and a common external trade policy is adopted. A common market is similar to a customs union, except that a common market also allows factors of production to move freely between countries. An economic union involves even closer integration, including the establishment of a common currency and the harmonization of tax rates. A political union is the logical culmination of attempts to achieve ever-closer economic integration.
3. Regional economic integration is an attempt to achieve economic gains from the free flow of trade and investment between neighboring countries.
4. Integration is not easily achieved or sustained. Although integration brings benefits to the majority, it is never without costs for the minority. Concerns over national sovereignty often slow or stop integration attempts.
5. Regional integration will not increase economic welfare if the trade creation effects in the free trade area are outweighed by the trade diversion effects.

6. The Single European Act sought to create a true single market by abolishing administrative barriers to the free flow of trade and investment between EU countries.
7. Twelve EU members now use a common currency, the euro. The economic gains from a common currency come from reduced exchange costs, reduced risk associated with currency fluctuations, and increased price competition within the EU.
8. Increasingly, the European Commission is taking an activist stance with regard to competition policy, intervening to restrict mergers and acquisitions that it believes will reduce competition in the EU.
9. Although no other attempt at regional economic integration comes close to the EU in terms of potential economic and political significance, various other attempts are being made in the world. The most notable include NAFTA in North America, the Andean Community and Mercosur in Latin America, ASEAN in Southeast Asia, and perhaps APEC.
10. The creation of single markets in the EU and North America means that many markets that were formerly protected from foreign competition are now more open. This creates major investment and export opportunities for firms within and outside these regions.
11. The free movement of goods across borders, the harmonization of product standards, and the simplification of tax regimes make it possible for firms based in a free trade area to realize potentially enormous cost economies by centralizing production in those locations within the area where the mix of factor costs and skills is optimal.
12. The lowering of barriers to trade and investment between countries within a trade group will probably be followed by increased price competition.

Critical Thinking and Discussion Questions

1. NAFTA has produced significant net benefits for the Canadian, Mexican, and U.S. economies. Discuss.
2. What are the economic and political arguments for regional economic integration? Given these arguments, why don't we see more substantial examples of integration in the world economy?
3. What effect is creation of a single market and a single currency within the EU likely to have on competition within the EU? Why?
4. Do you think it is correct for the European Commission to restrict mergers between American companies that do business in Europe? (For example, the European Commission vetoed the proposed merger between WorldCom and Sprint, both U.S. companies, and it carefully reviewed the merger between AOL and Time Warner, again both U.S. companies.)
5. How should a U.S. firm that currently exports only to ASEAN countries respond to the creation of a single market in this regional grouping?
6. How should a firm with self-sufficient production facilities in several ASEAN countries respond to the creation of a single market? What are the constraints on its ability to respond in a manner that minimizes production costs?
7. After a promising start, Mercosur, the major Latin American trade agreement, has faltered and made little progress since 2000. What problems are hurting Mercosur? What can be done to solve these problems?
8. Would establishment of a Free Trade Area of the Americas (FTAA) be good for the two most advanced economies in the hemisphere, the United States and Canada? How might the establishment of the FTAA impact the strategy of North American firms?
9. Reread the Management Focus, "The European Commission and Media Industry Mergers," then answer the following questions:
   a. Given that both AOL and Time Warner were U.S.-based companies, do you think the European Commission had a right to review and regulate their planned merger?
   b. Were the concessions extracted by the European Commission from AOL and Time Warner reasonable? Whose interests was the commission trying to protect?
   c. What precedent do the actions of the European Commission in this case set? What are the implications for managers of foreign enterprises with substantial operations in Europe?

Research Task globalEDGE globaledge.msu.edu

Regional Economic Integration

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

Your company is seeking to expand by opening new customer representative and sales offices in the European Union (EU). The size of the investment is significant, and top management wishes to have a clearer picture of the current and probable future status of the EU. A colleague who spent some time living in the EU indicated that *Eurostat* might be a comprehensive source to assist in your project. After evaluating the state of the EU based on the statistics and publications available, prepare an executive summary describing the features you consider as crucial in completing your report.

Exercise 2

Trade agreements can impact the cultural interactions between countries. In fact, the establishment of the Free Trade Area of the Americas (*FTAA*) can be considered a threat as well as an opportunity for your company. Identify the main negotiating groups a country must consider when a member. Choose two negotiating groups and justify their importance to member countries.

CLOSING CASE

NAFTA and Mexican Trucking

When the North American Free Trade Agreement (NAFTA) went into effect in 1994, the treaty specified that by 2000 trucks from each nation would be allowed to cross each other's borders and deliver goods to their ultimate destination. The argument was that such a policy would lead to great efficiencies. Before NAFTA, Mexican trucks stopped at the border, and goods had to be unloaded and reloaded onto American trucks, a process that took time and cost money. It was also argued that greater competition from Mexican trucking firms would lower the price of road transportation within NAFTA. Given that two-thirds of cross-border trade within NAFTA goes by road, supporters argued that the savings could be significant.

This provision was vigorously opposed by the Teamsters union in the United States, which represents truck drivers. The union argued that Mexican truck drivers had poor safety records, and that Mexican trucks did not adhere to the strict safety and environmental standards of the United States. To quote James Hoffa, the president of the Teamsters:

> Mexican trucks are older, dirtier, and more dangerous than American trucks. American truck drivers are taken off the road if they commit a serious traffic violation in their personal vehicle. That's not so in Mexico. Limits on the hours a driver can spend behind the wheel are ignored in Mexico.

Under pressure from the Teamsters, the United States dragged its feet on implementation of the trucking agreement. Ultimately the Teamsters sued to stop implementation of the agreement. An American court rejected their arguments and stated the country must honor the treaty. So did a NAFTA dispute settlement panel. This panel ruled in 2001 that the United States was violating the NAFTA treaty and gave Mexico the right to impose retaliatory tariffs. Mexico decided not to do that, instead giving the United States a chance to honor its commitment. The Bush administration tried to do just that, but was thwarted by opposition in Congress, which approved a measure setting 22 new safety standards that Mexican trucks would have to meet before entering the United States.

In an attempt to break the stalemate, in 2007 the U.S. government set up a pilot program under which trucks from some 100 Mexican transportation companies could enter the United States, provided they passed American safety inspections. The Mexican trucks were tracked, and after 18 months, that program showed the Mexican carriers had a slightly better safety record than their U.S. counterparts. The Teamsters immediately lobbied Congress to kill the pilot program. In March 2009 an amendment attached to a large spending bill did just that.

This time the Mexican government did not let the United States off the hook. As allowed to under the terms of the NAFTA agreement, Mexico immediately placed tariffs on some $2.4 billion of goods shipped from the United States to Mexico. California, an important exporter of agricultural products to Mexico, was hit hard. Table grapes now faced a 45 percent tariff, while wine, almonds, and juices

would pay a 20 percent tariff. Pears, which primarily come from Washington state, faced a 20 percent tariff (4 out of 10 pears that the United States exports go to Mexico). Other products hit with the 20 percent tariff include exports of personal hygiene products and jewelry from New York, tableware from Illinois, and oil seeds from North Dakota. The U.S. Chamber of Commerce has estimated that the current situation costs some 25,600 U.S. jobs. The U.S. government said it would try to come up with a new program that both addressed the "legitimate concerns" of Congress and honored its commitment to the NAFTA treaty. What that agreement will be, however, remains to be seen, and as of 2010, there was no agreement in sight.[50]

Case Discussion Questions

1. What are the potential economic benefits of the trucking provisions in the NAFTA treaty? Who benefits?
2. What do you think motivated the Teamsters to object to the trucking provisions in NAFTA? Are these objections fair? Why did Congress align itself with the Teamsters?
3. Does it make economic sense for the United States to bear the costs of punitive tariffs as allowed for under NAFTA, as opposed to letting Mexican trucks enter the United States?

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Logitech

Best known as one of the world's largest producers of computer mice, Logitech is in many ways the epitome of the modern global corporation. Founded in 1981 in Apples, Switzerland, by two Italians and a Swiss, the company now generates annual sales of over $2.2 billion, mostly from products such as mice, keyboards, and low-cost video cameras that cost less than $100. Logitech made its name as a technological innovator in the highly competitive business of personal computer peripherals. It was the first company to introduce a mouse that used infrared tracking, rather than a tracking ball, and the first to introduce wireless mice and keyboards. Logitech is differentiated from competitors by its continuing innovation, high brand recognition, and strong retail presence. Less obvious to consumers, but equally important, has been the way the company has configured its global value chain to lower production costs while maintaining the value of those assets that lead to differentiation.

Logitech still undertakes basic R&D work (primarily software programming) in Switzerland, where it has several hundred employees. The company is still legally Swiss, but most of the corporate functions are run out of offices in Fremont, California, close to many of America's high-technology enterprises, where it has more than 500 employees. Some R&D work (again, primarily software programming) is also carried out in Fremont. Most significantly, though, Fremont is the headquarters for the company's global marketing, finance, and logistics operations. The ergonomic design of Logitech's products—their look and feel—is done in Ireland by an outside design firm. Most of Logitech's products are manufactured in Asia.

Logitech's expansion into Asian manufacturing began in the late 1980s when it opened a factory in Taiwan. At the time, most of its mice were produced in the United States. Logitech was trying to win two of the most prestigious OEM customers—Apple Computer and IBM. Both bought their mice from Alps, a large Japanese firm that supplied Microsoft. To attract discerning customers such as Apple, Logitech not only needed the capacity to produce at high volume and low cost, but it also had to offer a better designed product. The solution: Manufacture in Taiwan. Cost was a factor in the decision, but it was not as significant as might be expected because direct labor accounted for only 7 percent of the cost of Logitech's mouse. Taiwan offered a well-developed supply base for parts, qualified people, and a rapidly expanding local computer industry. As an inducement to fledgling innovators, Taiwan provided space in its science-based industrial park in Hsinchu for the modest fee of $200,000. Sizing this up as a deal that was too good to pass up, Logitech signed the lease. Shortly afterward, Logitech won the OEM contract with Apple. The Taiwanese factory was soon outproducing Logitech's U.S. facility. After the Apple contract, Logitech's other OEM business started being served from Taiwan; the plant's total capacity increased to 10 million mice per year.

By the late 1990s, Logitech needed more production capacity. This time it turned to China. A wide variety of the company's retail products are now made there. A wireless infrared mouse called Wanda, one of Logitech's biggest sellers, is assembled in Suzhou, China, in a Logitech-owned factory. The factory employs 4,000 people, mostly young women such as Wang Yan, an 18-year-old employee from the impoverished rural province of Anhui. She is paid $75 a month to sit all day at a conveyer belt plugging three tiny bits of metal into circuit boards. She does this about 2,000 times each day. The mouse Wang Yan helps assemble sells to American consumers for about $40. Of this, Logitech takes about $8, which is used to fund R&D, marketing, and corporate overhead. What remains after that is the profit attributable to Logitech's shareholders. Distributors and retailers around the world take a further $15. Another $14 goes to the suppliers that make Wanda's parts. For example, a Motorola plant in Malaysia makes the mouse's chips and another American company, Agilent Technologies, supplies the optical sensors from a plant in the Philippines. That leaves just $3 for the Chinese factory, which is used to cover wages, power, transport, and other overhead costs.

Logitech is not alone in exploiting China to manufacture products. According to China's Ministry of Commerce, foreign companies account for three-quarters of China's high-tech exports. China's top 10 exporters include American companies with Chinese operations, such as Motorola and Seagate Technologies, a maker of disk drives for computers. Intel now produces some 50 million chips a year in China, the majority of which end up in computers and other goods that are exported to other parts of Asia, or back to the United States. Yet Intel's plant in Shanghai doesn't really make chips; it tests and assembles chips from silicon wafers made in Intel plants abroad, mostly in the United States. China adds less than 5 percent of the value. The U.S. operations of Intel generate the bulk of the value and profits.[1]

Case Discussion Questions

1. In a world without trade, what would happen to the costs that American consumers would have to pay for Logitech's products?
2. Explain how trade lowers the costs of making computer peripherals such as mice and keyboards.

3. Use the theory of comparative advantage to explain the way in which Logitech has configured its global operations. Why does the company manufacture in China and Taiwan, undertake basic R&D in California and Switzerland, design products in Ireland, and coordinate marketing and operations from California?
4. Who creates more value for Logitech, the 650 people it employees in Fremont and Switzerland, or the 4,000 employees at its Chinese factory? What are the implications of this observation for the argument that free trade is beneficial?
5. Why do you think the company decided to shift its corporate headquarters from Switzerland to Fremont?
6. To what extent can Porter's diamond help explain the choice of Taiwan as a major manufacturing site for Logitech?
7. Why do you think China is now a favored location for so much high-technology manufacturing activity? How will China's increasing involvement in global trade help that country? How will it help the world's developed economies? What potential problems are associated with moving work to China?

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The Ecuadorean Rose Industry

It is 6:20 a.m. February 7 in the Ecuadorean town of Cayambe, and Maria Pacheco has just been dropped off for work by the company bus. She pulls on thick rubber gloves, wraps an apron over her white, traditional embroidered dress, and grabs her clippers, ready for another long day. Any other time of year, Maria would work until 2 p.m., but it's a week before Valentine's Day, and Maria along with her 84 coworkers at the farm are likely to be busy until 5 p.m. By then, Maria will have cut more than 1,000 rose stems.

A few days later, after they have been refrigerated and shipped via aircraft, the roses Maria cut will be selling for premium prices in stores from New York to London. Ecuadorean roses are quickly becoming the Rolls-Royce of roses. They have huge heads and unusually vibrant colors, including 10 different reds, from bleeding heart crimson to a rosy lover's blush.

Most of Ecuador's 460 or so rose farms are located in the Cayambe and Cotopaxi regions, 10,000 feet up in the Andes about an hour's drive from the capital, Quito. The rose bushes are planted in huge flat fields at the foot of snowcapped volcanoes that rise to more than 20,000 feet. The bushes are protected by 20-foot-high canopies of plastic sheeting. The combination of intense sunlight, fertile volcanic soil, an equatorial location, and high altitude makes for ideal growing conditions, allowing roses to flower almost year-round. Ecuador apparently has a comparative advantage in the production of roses.

Ecuador's rose industry started some 20 years ago and has been expanding rapidly since. Ecuador is now the world's fourth-largest producer of roses. Roses are the nation's fifth-largest export, with customers all over the world. Rose farms generate $240 million in sales and support tens of thousands of jobs. In Cayambe, the population has increased in 10 years from 10,000 to 70,000, primarily as a result of the rose industry. The revenues and taxes from rose growers have helped to pave roads, build schools, and construct sophisticated irrigation systems.

Maria works Monday to Saturday, and earns $210 a month, which she says is an average wage in Ecuador and substantially above the country's $120 a month minimum wage. The farm also provides her with health care and a pension. By employing women such as Maria, the industry has fostered a social revolution in which mothers and wives have more control over their family's spending, especially on schooling for their children.

For all of the benefits that roses have bought to Ecuador, where the gross national income per capita is only $1,080 a year, the industry has come under fire from environmentalists. Large growers have been accused of misusing a toxic mixture of pesticides, fungicides, and fumigants to grow and export unblemished pest-free flowers. Reports claim that workers often fumigate roses in street clothes without protective equipment. Some doctors and scientists claim that many of the industry's 50,000 employees have serious health problems as a result of exposure to toxic chemicals. A study by the International Labor Organization claimed that women in the industry had more miscarriages than average and that some 60 percent of all workers suffered from headaches, nausea, blurred vision, and fatigue. Still, the critics acknowledge that their studies have been hindered by a lack of access to the farms, and they do not know what the true situation is. The International Labor Organization has also claimed that

some rose growers in Ecuador use child labor, a claim that has been strenuously rejected by both the growers and Ecuadorean government agencies.

In Europe, consumer groups have urged the European Union to press for improved environmental safeguards. In response, some Ecuadorean growers have joined a voluntary program aimed at helping customers identify responsible growers. The certification signifies that the grower has distributed protective gear, trained workers in using chemicals, and hired doctors to visit workers at least weekly. Other environmental groups have pushed for stronger sanctions, including trade sanctions, against Ecuadorean rose growers that are not environmentally certified by a reputable agency. On February 14, however, most consumers are oblivious to these issues; they simply want to show their appreciation to their wives and girlfriends with a perfect bunch of roses.[1]

Case Discussion Questions

1. What is the basis of Ecuador's comparative advantage in the production of roses?
2. Most Ecuadorean roses are sold in the United States or Europe. Who in these countries benefits from the importation of Ecuadorean roses, and how do they benefit? Who loses? Do you think the benefits outweigh the costs?
3. How does the rose export industry benefit Ecuador? Do these benefits have any implications for the United States and Europe?
4. How should developed nations respond to reports of poor working conditions in this industry? Should importers in some way certify Ecuadorean producers, only importing from those who adhere to strict labor and environmental standards?

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The European Energy Market

For several years the European Union, the largest regional trading bloc in the world, has been trying to liberalize its energy market, replacing the markets of its 27 member states with a single continentwide market for electricity and gas. The first phase of liberalization went into effect in June 2007. When fully implemented, the ability of energy producers to sell electricity and gas across national borders will increase competition. The road toward the creation of a single EU energy market, however, has been anything but easy. Many national markets are dominated by a single enterprise, often a former state-owned utility. Electricitie de France, for example, has an 87 percent share of that country's electricity market. Injecting competition into such concentrated markets will prove difficult.

To complicate matters, most of these utilities are vertically integrated, producing, transmitting, and selling power. These vertically integrated producers have little interest in letting other utilities use their transmission grids to sell power to end users, or in buying power from other producers. For the full benefits of competition to take hold, the EU recognizes that utilities need to be split into generation, transmission, and marketing companies so that the business of selling energy can be separated from the businesses of producing it and transmitting it. Only then, so the thinking goes, will independent power marketing companies be able to buy energy from the cheapest source, whether it is within national borders or elsewhere in the EU, and resell it to consumers, thereby promoting competition.

For now, efforts to mandate the deintegration of utilities are some way off. In February 2007 national energy ministers from the different EU states rejected a call from the European Commission, the top competition body in the EU, to break apart utilities. Instead the energy ministers asked the commission for more details about what such a move would accomplish, thereby effectively delaying any attempt to deintegrate national power companies. In mid-2008, they reached a compromise that fell short of mandating the unbundling, or deintegration, of national energy companies due to powerful opposition from France and Germany among others (both nations have large vertically integrated energy companies).

The response of established utilities to the creation of a single continentwide market for energy has been to try to acquire utilities in other EU nations in an effort to build systems that serve more than one country. The underlying logic is that larger utilities should be able to realize economies of scale, and this would enable them to compete more effectively in a liberalized market. However, some cross-border takeover bids have run into fierce opposition from local politicians who resent their "national energy companies" being taken over by foreign entities. Most notably, when E.ON, the largest German utility, made a bid to acquire Endesa, Spain's largest

utility, in 2006, Spanish politicians sought to block the acquisition and keep ownership of Endesa in Spanish hands, imposing conditions on the deal that were designed to stop the Germans from acquiring the Spanish company. In response to this outburst of nationalism, the European Commission took the Spanish government to the European Union's highest court, arguing that Madrid had violated the commission's exclusive powers within the EU to scrutinize and approve big cross-border mergers in Europe. Subsequently, Enel, Italy's biggest power company, stepped in and purchased Endesa.[1]

Case Discussion Questions

1. What do you think are the economic benefits of liberalizing the EU energy market? Who stands to gain the most from liberalization?
2. What are the implications of liberalization for energy producers in the EU? How will the environment they face change after liberalization. What actions will they have to take?
3. Why is the deintegration of large energy companies seen as such an important part of any attempt to liberalize the EU energy market?
4. Why do you think progress toward the liberalization of the EU energy market has been fairly slow so far?

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Global Food Prices

For the past 25 years global food prices have been falling, driven by the increased productivity and output of the farm sector worldwide. In 2007, this came to an abrupt end as global food prices soared. By September 2007, the world price of wheat rose to over $400 a ton–the highest ever recorded and up from $200 a ton in May. The price of corn (maize) surged to $175 a ton, some 60 percent above its average for 2006. An index of food prices, which *The Economist* magazine has kept since 1845 and adjusts for inflation, hit its highest level ever in December 2007!

One explanation for rising food prices has been increased demand. The increased demand has been driven by greater food consumption in rapidly developing nations, most notably China and India. Rising consumption of meat, in particular, has driven up demand for grains; it takes eight kilograms of cereals to produce one kilogram of beef, so as demand for meat rises, consumption of grains by cattle surges. Farmers now feed 200 million to 250 million tons more of grain to their animals than they did 20 years ago, driving up grain prices.

Then there is the issue of biofuel subsidies. Both the United States and the European Union have adopted policies to increase production of ethanol and biodiesel to slow global warming (both products are argued to produce fewer CO_2 emissions, although exactly how effective they are at doing this is actively debated). In 2000, about 15 million tons of American corn was turned into ethanol; in 2007 the figure reached 85 million tons. To promote increased production, governments have given subsidies to farmers. In the United States, subsidies amount to between $0.29 and $0.36 per liter of ethanol. In Europe, the subsidies are as high as $1 a liter. Not surprisingly, the subsidies have created an incentive for farmers to plant more crops that can be turned into biofuels (primarily corn and soybeans). This has diverted land away from production of corn and soy for food, and reduced the supply of land devoted to growing crops that don't receive biofuel subsidies, such as wheat. This highly subsidized source of demand seems to be having a dramatic effect on demand for corn and soybeans. In 2007, for example, the U.S. increase in demand for corn-based ethanol accounted for more than half of the global increase in demand for corn.

Producers of alternative products that can be turned into biofuels, most notably sugarcane, are being shut out of the American and EU markets by high tariffs. Brazil, the world's most efficient producer of sugarcane, confronts import tariffs of at least 25 percent by value in the United States and 50 percent in the EU, raising the price of imported sugarcane and making it uncompetitive with subsidized corn and soybeans. This is unfortunate because sugarcane is widely seen as a more environmentally friendly raw material for biofuels than either corn or soybeans. Sugarcane uses less fertilizer than corn or soybeans and produces a higher yield per hectare, in terms of its energy content. Ethanol is also produced from what used to be considered a waste product, the fiber removed from the cane during processing.

If policy makers have their way, however, the situation may get even worse. Plans in both the United States and

EU call for an increase in the production of biofuels, but neither political entity has agreed to reduce tariff barriers on sugarcane or remove the trade-distorting subsidies given to those who produce corn and soybeans for biofuels. Brazil is not sitting on the sidelines; in 2007 it asked the World Trade Organization to probe U.S. subsidies to corn farmers for ethanol production.[1]

Case Discussion Questions

1. Who benefits from government policies to (a) promote production of ethanol and (b) place tariff barriers on imports of sugarcane? Who suffers from these policies?
2. One estimate suggests that if food prices rise by one-third, they will reduce living standards in rich countries by about 3 percent, but in very poor ones by about 20 percent. According to the International Food Policy Research Institute, unless there is a change in policies cereal prices will rise by 10 to 20 percent by 2015, and the expansion of biofuel production could reduce calorie intake by 2 to 8 percent by 2020 in many of the world's poorest nations. Should rich countries do anything about this? If so, what?
3. The argument for giving subsidies to ethanol producers rests upon the assumption that ethanol results in lower CO_2 emissions than gasoline, and therefore benefits the environment. If we accept that global warming is itself a serious problem, should we not be encouraging government to increase such subsidies? What are the arguments for and against doing so? On balance, what do you think is the best policy?

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part four The Global Monetary System

10 The Foreign Exchange Market

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Describe the functions of the foreign exchange market.
- **LO2** Understand what is meant by spot exchange rates.
- **LO3** Recognize the role that forward exchange rates play in insuring against foreign exchange risk.
- **LO4** Understand the different theories explaining how currency exchange rates are determined and their relative merits.
- **LO5** Identify the merits of different approaches toward exchange rate forecasting.
- **LO6** Compare and contrast the differences between translation, transaction, and economic exposure, and what managers can do to manage each type of exposure.

Billabong

Billabong is a quintessential Australian company. The maker of "surf wear" from wet suits and board shorts to T-shirts and watches has a powerful brand name that is recognized by surfing enthusiasts around the globe. The company is a major exporter. Some 80 percent of its sales are generated outside of Australia through a network of 10,0000 outlets in more than 100 countries. Not surprisingly given the history of surfing, the largest foreign market for Billabong is the United States, which accounts for about 50 percent of the company's $800 million in annual sales. As a result, Billabong's fortunes are closely linked to the value of the Australian dollar against the U.S. dollar. When the Australian dollar falls against the U.S. dollar, Billabong's products become less expensive in U.S. dollars, and this can drive sales forward. Conversely, if the Australian dollar rises in value, this can raise the price of Billabong's products in terms of U.S. dollars, which impacts sales negatively. Billabong's CEO has stated that every 1 cent movement in the U.S. dollar/Australian dollar exchange rate means a 0.6 percent change in profit for Billabong.

During the second half of 2008 it looked as if things were going Billabong's way. The Australian dollar fell rapidly in value against the U.S. dollar. In June 2008 one Australian dollar was worth $0.97. By October 2008 it was worth only $0.60. The fall in the value of the Australian dollar was in part due to a fear among currency traders that as the world slipped into a recession, caused by the 2008–2009 global financial crisis, global demand for many of the raw materials produced in Australia would decline, exports would slump, and Australia's trade balance would deteriorate. In anticipation of this, institutions sold Australian dollars, driving down their value on foreign exchange markets. For Billabong, however, this was something of a blessing. The cheaper Australian dollar would give it a pricing advantage and help to



promote sales in the United States and elsewhere. Also, when sales in U.S. dollars were translated back into Australian dollars, their value increased as the Australian dollar fell. Anticipating this, in February 2009 Billabong's CEO affirmed that he expected the company to increase its profits by as much as 10 percent in 2009, despite the weak global retail environment.

Currency markets, however, can be difficult to predict, and sharp reversals do occur. Between March and November 2009 the Australian dollar surged in value, rising all the way back to $0.94 to one Australian dollar. The cause was twofold. First, there was a global sell-off of the American dollar as the full impact of the global financial crisis became apparent, and as the scale of debt in the United States became clearer. Second, despite a recession in the United States and Europe, the emerging economies of China and India continued to grow, and this helped to support demand for many of the basic commodities that Australia exports, which led to a strengthening of the Australian dollar. For Billabong, the sharp reversal was an embarrassment. The strong Australian dollar eradicated any pricing advantage Billabong might have enjoyed. Now the amount of Australian dollars that the company received for every sale made in U.S. dollars was declining. In February 2009 every $1 earned in U.S. currency could be exchanged for $1.66 in Australian dollars. By October 2009 every $1 earned in U.S. currency could only be exchanged for $1.06 in Australian dollars. In May 2009, with the Australian dollar rising rapidly, the CEO was forced to revise his previously bullish forecast for sales and earnings. Now, he said, a combination of weaker than expected demand in the United States, plus a strengthening Australian dollar, would lead to a 10 percent decline in profits for 2009.[1]

Introduction

Like many enterprises in the global economy, Billabong is impacted by changes in the value of currencies on the foreign exchange market. As detailed in the opening case, during late 2008 and early 2009 it looked as if the weak Australian dollar would help to boost Billabong's exports of surf wear to markets such as the United States, and the company issued bullish profit forecasts. By May 2009, an unanticipated rise in the value of the Australian dollar forced the company to revise its earnings forecasts for 2009 downward. As stated in the case, every 1 cent movement in the U.S. dollar/Australian dollar exchange rate means a 0.6 percent change in profit for Billabong. When the Australian dollar appreciates again the U.S. dollar, Billabong's products became more expensive in U.S. dollar terms, effectively putting the company at a price disadvantage in the United States, its major foreign market.

What happens in the foreign exchange market can have a fundamental impact on the sales, profits, and strategy of an enterprise. Accordingly, it is very important for managers to understand the foreign exchange market, and what the impact of changes in currency exchange rates might be for their enterprise. With this in mind, the current chapter has three main objectives. The first is to explain how the foreign exchange market works. The second is to examine the forces that determine exchange rates, and to discuss the degree to which it is possible to predict future exchange rate movements. The third objective is to map the implications for international business of exchange rate movements. This chapter is the first of two that deal with the international monetary system and its relationship to international business. The next chapter explores the institutional structure of the international monetary system. The institutional structure is the context within which the foreign exchange market functions. As we shall see, changes in the institutional structure of the international monetary system can exert a profound influence on the development of foreign exchange markets.

The **foreign exchange market** is a market for converting the currency of one country into that of another country. An **exchange rate** is simply the rate at which one currency is converted into another. For example, Billabong uses the foreign exchange market to convert the dollars it earns from selling surf wear in the United States into Australian dollars. Without the foreign exchange market, international trade and international investment on the scale that we see today would be impossible; companies would have to resort to barter. The foreign exchange market is the lubricant that enables companies based in countries that use different currencies to trade with each other.

We know from earlier chapters that international trade and investment have their risks. Some of these risks exist because future exchange rates cannot be perfectly predicted. The rate at which one currency is converted into another can change over time. For example, at the start of 2001 one U.S. dollar bought 1.065 euros, but by the start of 2011, one U.S. dollar only bought 0.74 euro. The dollar had fallen sharply in value against the euro. This made American goods cheaper in Europe, boosting export sales. At the same time, it made European goods more expensive in the United States, which hurt the sales and profits of European companies that sold goods and services to the United States.

One function of the foreign exchange market is to provide some insurance against the risks that arise from such volatile changes in exchange rates, commonly referred to as foreign exchange risk. Although the foreign exchange market offers some insurance against foreign exchange risk, it cannot provide complete insurance. It is not unusual for international businesses to suffer losses because of unpredicted changes in exchange rates. Currency fluctuations can make seemingly profitable trade and investment deals unprofitable, and vice versa.

We begin this chapter by looking at the functions and the form of the foreign exchange market. This includes distinguishing among spot exchanges, forward exchanges, and currency swaps. Then we will consider the factors that determine exchange rates. We will also look at how foreign trade is conducted when a country's currency cannot be

exchanged for other currencies, that is, when its currency is not convertible. The chapter closes with a discussion of these things in terms of their implications for business.

The Functions of the Foreign Exchange Market LO1

The foreign exchange market serves two main functions. The first is to convert the currency of one country into the currency of another. The second is to provide some insurance against **foreign exchange risk**, or the adverse consequences of unpredictable changes in exchange rates.[2]

CURRENCY CONVERSION

Each country has a currency in which the prices of goods and services are quoted. In the United States, it is the dollar ($); in Great Britain, the pound (£); in France, Germany, and other members of the euro zone it is the euro (€); in Japan, the yen (¥); and so on. In general, within the borders of a particular country, one must use the national currency. A U.S. tourist cannot walk into a store in Edinburgh, Scotland, and use U.S. dollars to buy a bottle of Scotch whisky. Dollars are not recognized as legal tender in Scotland; the tourist must use British pounds. Fortunately, the tourist can go to a bank and exchange her dollars for pounds. Then she can buy the whisky.

When a tourist changes one currency into another, she is participating in the foreign exchange market. The exchange rate is the rate at which the market converts one currency into another. For example, an exchange rate of €1 = $1.30 specifies that one euro buys $1.30 U.S. dollars. The exchange rate allows us to compare the relative prices of goods and services in different countries. Our U.S. tourist wishing to buy a bottle of Scotch whisky in Edinburgh may find that she must pay £30 for the bottle, knowing that the same bottle costs $45 in the United States. Is this a good deal? Imagine the current pound/dollar exchange rate is £1.00 = $2.00 (i.e., one British pound buys $2.00). Our intrepid tourist takes out her calculator and converts £30 into dollars. (The calculation is 30 × 2.) She finds that the bottle of Scotch costs the equivalent of $60. She is surprised that a bottle of Scotch whisky could cost less in the United States than in Scotland (alcohol is taxed heavily in Great Britain).



The foreign exchange market enables companies based in countries that use different currencies to trade with each other.

Tourists are minor participants in the foreign exchange market; companies engaged in international trade and investment are major ones. International businesses have four main uses of foreign exchange markets. First, the payments a company receives for its exports, the income it receives from foreign investments, or the income it receives from licensing agreements with foreign firms may be in foreign currencies. To use those funds in its home country, the company must convert them to its home country's currency. Consider the Scotch distillery that exports its whisky to the United States. The distillery is paid in dollars, but since those dollars cannot be spent in Great Britain, they must be converted into British pounds. Similarly, Billabong sells its surfing products in the United States for dollars; it must convert the U.S. dollars it receives into Australian dollars to use them in Australia.

Second, international businesses use foreign exchange markets when they must pay a foreign company for its products or services in its country's currency. For example, Dell buys many of the components for its computers from Malaysian firms. The Malaysian companies must be paid in Malaysia's currency, the ringgit, so Dell must convert money from dollars into ringgit to pay them.

Third, international businesses also use foreign exchange markets when they have spare cash that they wish to invest for short terms in money markets. For example, consider a U.S. company that has $10 million it wants to invest for three months. The best interest rate it can earn on these funds in the United States may be 4 percent. Investing in a South Korean money market account, however, may earn 12 percent. Thus, the company may change its $10 million into Korean won and invest it in South Korea. Note, however, that the rate of return it earns on this investment depends not only on the Korean interest rate, but also on the changes in the value of the Korean won against the dollar in the intervening period.

Currency speculation is another use of foreign exchange markets. **Currency speculation** typically involves the short-term movement of funds from one currency to another in the hopes of profiting from shifts in exchange rates. Consider again a U.S. company with $10 million to invest for three months. Suppose the company suspects that the U.S. dollar is overvalued against the Japanese yen. That is, the company expects the value of the dollar to depreciate (fall) against that of the yen. Imagine the current dollar/yen exchange rate is $1 = ¥120. The company exchanges its $10 million into yen, receiving ¥1.2 billion ($10 million × 120 = ¥1.2 billion). Over the next three months, the value of the dollar depreciates against the yen until $1 = ¥100. Now the company exchanges its ¥1.2 billion back into dollars and finds that it has $12 million. The company has made a $2 million profit on currency speculation in three months on an initial investment of $10 million! In general, however, companies should beware, for speculation by definition is a very risky business. The company cannot know for sure what will happen to exchange rates. While a speculator may profit handsomely if his speculation about future currency movements turns out to be correct, he can also lose vast amounts of money if it turns out to be wrong.

A kind of speculation that has become more common in recent years is known as the **carry trade**. The carry trade involves borrowing in one currency where interest rates are low, and then using the proceeds to invest in another currency where interest rates are high. For example, if the interest rate on borrowings in Japan is 1 percent, but the interest rate on deposits in American banks is 6 percent, it can make sense to borrow in Japanese yen, then convert the money into U.S. dollars and deposit it in an American bank. The trader can make a 5 percent margin by doing so, minus the transaction costs associated with changing one currency into another. The speculative element of this trade is that its success is based upon a belief that there will be no adverse movement in exchange rates (or interest rates for that matter) that will make the trade unprofitable. However, if the yen were to rapidly increase in value against the dollar, then it would take more U.S. dollars to repay the original loan, and the trade could fast become unprofitable. The dollar–yen carry trade was actually very significant during the mid-2000s, peaking at more than $1 trillion in 2007, when some 30 percent of trade on

the Tokyo foreign exchange market was related to the carry trade.[3] This carry trade declined in importance during 2008–2009 precisely because the Japanese yen was increasing in value against the dollar, making the trade riskier (in addition, interest rate differentials were falling as U.S. rates came down, making the trade less profitable even if exchange rates were stable).

INSURING AGAINST FOREIGN EXCHANGE RISK LO²

A second function of the foreign exchange market is to provide insurance against **foreign exchange risk**, which is the possibility that unpredicted changes in future exchange rates will have adverse consequences for the firm. When a firm insures itself against foreign exchange risk, it is engaging in *hedging*. To explain how the market performs this function, we must first distinguish among spot exchange rates, forward exchange rates, and currency swaps.

Spot Exchange Rates

When two parties agree to exchange currency and execute the deal immediately, the transaction is referred to as a spot exchange. Exchange rates governing such "on the spot" trades are referred to as spot exchange rates. The **spot exchange rate** is the rate at which a foreign exchange dealer converts one currency into another currency on a particular day. Thus, when our U.S. tourist in Edinburgh goes to a bank to convert her dollars into pounds, the exchange rate is the spot rate for that day.

Spot exchange rates are reported on a real-time basis on many financial websites. Table 10.1 shows the exchange rates for a selection of currencies traded in the New York foreign exchange market as of 11 a.m. February 11, 2011. An exchange rate can be quoted in two ways: as the amount of foreign currency one U.S. dollar will buy, or as the value of a dollar for one unit of foreign currency. Thus, one U.S. dollar bought €0.7379 at this point in time, and one euro bought $1.3553 U.S. dollars.

Spot rates change continually, often on a minute-by-minute basis (although the magnitude of changes over such short periods is usually small). The value of a currency is determined by the interaction between the demand and supply of that currency relative to the demand and supply of other currencies. For example, if lots of people want U.S. dollars and dollars are in short supply, and few people want British pounds and pounds

		Major Currency Cross Rates						
Currency Last Trade		U.S. $ N/A	¥en 1:22pm ET	Euro 1:22pm ET	Can $ 1:22pm ET	U.K. £ 1:20pm ET	AU $ 1:22pm ET	Swiss Franc 1:22pm ET
1 U.S. $	=	1	83.3650	0.7379	0.9892	0.6247	0.9979	0.9722
1 ¥en	=	0.0120	1	0.0089	0.0119	0.0075	0.0120	0.0117
1 Euro	=	1.3553	112.9805	1	1.3406	0.8466	1.3542	1.3175
1 Can $	=	1.01091	84.2752	0.7459	1	0.6315	1.0088	0.9828
1 U.K. £	=	1.6008	133.4532	1.1812	1.5835	1	1.5975	1.5563
1 AU $	=	1.0021	83.5401	0.7394	0.9913	0.6260	1	0.9742
1 Swiss Franc	=	1.0286	85.7510	0.7590	1.0175	0.6426	1.0265	1

TABLE 10.1

Value of the U.S. Dollar Against Other Currencies, February 11, 2011

Source: Yahoo Finance.

are in plentiful supply, the spot exchange rate for converting dollars into pounds will change. The dollar is likely to appreciate against the pound (or, the pound will depreciate against the dollar). Imagine the spot exchange rate is £1 = $2.00 when the market opens. As the day progresses, dealers demand more dollars and fewer pounds. By the end of the day, the spot exchange rate might be £1 = $1.98. Each pound now buys fewer dollars than at the start of the day. The dollar has appreciated, and the pound has depreciated.

LO3 Forward Exchange Rates

Changes in spot exchange rates can be problematic for an international business. For example, a U.S. company that imports laptop computers from Japan knows that in 30 days it must pay yen to a Japanese supplier when a shipment arrives. The company will pay the Japanese supplier ¥200,000 for each laptop computer, and the current dollar/yen spot exchange rate is $1 = ¥120. At this rate, each computer costs the importer $1,667 (i.e., 1,667 = 200,000/120). The importer knows she can sell the computers the day they arrive for $2,000 each, which yields a gross profit of $333 on each computer ($2,000 − $1,667). However, the importer will not have the funds to pay the Japanese supplier until the computers have been sold. If over the next 30 days the dollar unexpectedly depreciates against the yen, say, to $1 = ¥95, the importer will still have to pay the Japanese company ¥200,000 per computer, but in dollar terms that would be equivalent to $2,105 per computer, which is more than she can sell the computers for. A depreciation in the value of the dollar against the yen from $1 = ¥120 to $1 = ¥95 would transform a profitable deal into an unprofitable one.

To *insure* or *hedge* against this risk, the U.S. importer might want to engage in a forward exchange. A **forward exchange** occurs when two parties agree to exchange currency and execute the deal at some specific date in the future. Exchange rates governing such future transactions are referred to as **forward exchange rates**. For most major currencies, forward exchange rates are quoted for 30 days, 90 days, and 180 days into the future. In some cases, it is possible to get forward exchange rates for several years into the future. Returning to our computer importer example, let us assume the 30-day forward exchange rate for converting dollars into yen is $1 = ¥110. The importer enters into a 30-day forward exchange transaction with a foreign exchange dealer at this rate and is guaranteed that she will have to pay no more than $1,818 for each computer (1,818 = 200,000/110). This guarantees her a profit of $182 per computer ($2,000 − $1,818). She also insures herself against the possibility that an unanticipated change in the dollar/yen exchange rate will turn a profitable deal into an unprofitable one.

In this example, the spot exchange rate ($1 = ¥120) and the 30-day forward rate ($1 = ¥110) differ. Such differences are normal; they reflect the expectations of the foreign exchange market about future currency movements. In our example, the fact that $1 bought more yen with a spot exchange than with a 30-day forward exchange indicates foreign exchange dealers expected the dollar to depreciate against the yen in the next 30 days. When this occurs, we say the dollar is selling at a discount on the 30-day forward market (i.e., it is worth less than on the spot market). Of course, the opposite can also occur. If the 30-day forward exchange rate were $1 = ¥130, for example, $1 would buy more yen with a forward exchange than with a spot exchange. In such a case, we say the dollar is selling at a premium on the 30-day forward market. This reflects the foreign exchange dealers' expectations that the dollar will appreciate against the yen over the next 30 days.

In sum, when a firm enters into a forward exchange contract, it is taking out insurance against the possibility that future exchange rate movements will make a transaction unprofitable by the time that transaction has been executed. Although many firms routinely enter into forward exchange contracts to hedge their foreign exchange risk, there are some spectacular examples of what happens when firms don't take out this insurance. An example is given in the accompanying Management Focus, which explains how a failure to fully insure against foreign exchange risk cost Volkswagen dearly.

MANAGEMENT FOCUS

Volkswagen's Hedging Strategy

In January 2004, Volkswagen, Europe's largest carmaker, reported a 95 percent drop in 2003 fourth-quarter profits, which slumped from €1.05 billion to a mere €50 million. For all of 2003 Volkswagen's operating profit fell by 50 percent from the record levels attained in 2002. Although the profit slump had multiple causes, two factors were the focus of much attention—the sharp rise in the value of the euro against the dollar during 2003, and Volkswagen's decision to only hedge 30 percent of its foreign currency exposure, as opposed to the 70 percent it had traditionally hedged. In total, currency losses due to the dollar's rise are estimated to have reduced Volkswagen's operating profits by some €1.2 billion ($1.5 billion).

The rise in the value of the euro during 2003 took many companies by surprise. Since its introduction January 1, 1999, when it became the currency unit of 12 members of the European Union, the euro had recorded a volatile trading history against the U.S. dollar. In early 1999 the exchange rate stood at €1 = $1.17, but by October 2000 it had slumped to €1 = $0.83. Although it recovered, reaching parity of €1 = $1.00 in late 2002, few analysts predicted a rapid rise in the value of the euro against the dollar during 2003. As so often happens in the foreign exchange markets, the experts were wrong; by late 2003 the exchange rate stood at €1 = $1.25.

For Volkswagen, which made cars in Germany and exported them to the United States, the fall in the value of the dollar against the euro during 2003 was devastating. To understand what happened, consider a Volkswagen Jetta built in Germany for export to the United States. The Jetta costs €14,000 to make in Germany and ship to a dealer in the United States, where it sells for $15,000. With the exchange rate standing at around €1 = $1.00, the $15,000 earned from the sale of a Jetta in the U.S. could be converted into €15,000, giving Volkswagen a profit of €1,000 on every Jetta sold. But if the exchange rate changes during the year, ending up at €1 = $1.25 as it did during 2003, each dollar of revenue will now only buy €0.80 (€1/$1.25 = €0.80), and Volkswagen is squeezed. At an exchange rate of €1 = $1.25, the $15,000 Volkswagen gets for the Jetta is now worth only €12,000 when converted back into euros, meaning the company will lose €2,000 on every Jetta sold (when the exchange rate is €1 = $1.25, $15,000/1.25 = €12,000).

Volkswagen could have insured against this adverse movement in exchange rates by entering the foreign exchange market in late 2002 and buying a *forward contract* for dollars at an exchange rate of around $1 = €1 (a *forward contract* gives the holder the right to exchange one currency for another at some point in the future at a predetermined exchange rate). Called *hedging*, the financial strategy of buying forward guarantees that at some future point, such as 180 days, Volkswagen would have been able to exchange the dollars it got from selling Jettas in the United States into euros at $1 = €1, *irrespective of what the actual exchange rate was at that time*. In 2003 such a strategy would have been good for Volkswagen. However, hedging is not without its costs. For one thing, if the euro had declined in value against the dollar, instead of appreciating as it did, Volkswagen would have made even more profit per car in euros by not hedging (a dollar at the end of 2003 would have bought more euros than a dollar at the end of 2002). For another thing, hedging is expensive since foreign exchange dealers will charge a high commission for selling currency forward. Volkswagen decided to hedge just 30 percent of its anticipated U.S. sales in 2003 through forward contracts, rather than the 70 percent it had historically hedged. The decision cost the company more than €1 billion. For 2004, the company reverted back to hedging 70 percent of its foreign currency exposure.[4]

Currency Swaps

The above discussion of spot and forward exchange rates might lead you to conclude that the option to buy forward is very important to companies engaged in international trade—and you would be right. By April 2010, forward instruments accounted for some 63 percent of all foreign exchange transactions, while spot exchanges accounted for 37 percent.[5] However, the vast majority of these forward exchanges were not forward exchanges of the type we have been discussing, but rather a more sophisticated instrument known as currency swaps.

A **currency swap** is the simultaneous purchase and sale of a given amount of foreign exchange for two different value dates. Swaps are transacted between international businesses and their banks, between banks, and between governments when it is desirable to move out of one currency into another for a limited period without incurring foreign exchange risk. A common kind of swap is spot against forward. Consider a company such as Apple Computer. Apple assembles laptop computers in the United States, but the screens are made in Japan. Apple also sells some of the finished laptops in Japan. So, like many companies, Apple both buys from and sells to Japan. Imagine Apple needs to change $1 million into yen to pay its supplier of laptop screens today. Apple knows that in 90 days it will be paid ¥120 million by the Japanese importer that buys its finished laptops. It will want to convert these yen into dollars for use in the United States. Let us say today's spot exchange rate is $1 = ¥120 and the 90-day forward exchange rate is $1 = ¥110. Apple sells $1 million to its bank in return for ¥120 million. Now Apple can pay its Japanese supplier. At the same time, Apple enters into a 90-day forward exchange deal with its bank for converting ¥120 million into dollars. Thus, in 90 days Apple will receive $1.09 million (¥120 million/110 = $1.09 million). Since the yen is trading at a premium on the 90-day forward market, Apple ends up with more dollars than it started with (although the opposite could also occur). The swap deal is just like a conventional forward deal in one important respect: It enables Apple to insure itself against foreign exchange risk. By engaging in a swap, Apple knows today that the ¥120 million payment it will receive in 90 days will yield $1.09 million.

The Nature of the Foreign Exchange Market

The foreign exchange market is not located in any one place. It is a global network of banks, brokers, and foreign exchange dealers connected by electronic communications systems. When companies wish to convert currencies, they typically go through their own banks rather than entering the market directly. The foreign exchange market has been growing at a rapid pace, reflecting a general growth in the volume of cross-border trade and investment (see Chapter 1). In March 1986, the average total value of global foreign exchange trading was about $200 billion per day. According to the triannual survey by the Bank of International Settlements, by April 1995, it was more than $1,200 billion per day, by April 2007 it had surged to $3.21 trillion per day, and by April 2010 it had hit $4 trillion a day.[6] The most important trading centers are London (37 percent of activity), New York (18 percent of activity), and Zurich, Tokyo, and Singapore (all with around 5 to 6 percent of activity).[7] Major secondary trading centers include Frankfurt, Paris, Hong Kong, and Sydney.

London's dominance in the foreign exchange market is due to both history and geography. As the capital of the world's first major industrial trading nation, London had become the world's largest center for international banking by the end of the nineteenth century, a position it has retained. Today London's central position between Tokyo and Singapore to the east and New York to the west has made it the critical link between the East Asian and New York markets. Due to the particular differences in time zones, London opens soon after Tokyo closes for the night and is still open for the first few hours of trading in New York.[8]

Two features of the foreign exchange market are of particular note. The first is that the market never sleeps. Tokyo, London, and New York are all shut for only 3 hours out of every 24. During these three hours, trading continues in a number of minor centers, particularly San Francisco and Sydney, Australia. The second feature of the market is the integration of the various trading centers. High-speed computer linkages between trading centers around the globe have effectively created a single market. The integration of financial centers implies there can be no significant difference in exchange rates quoted in the trading centers. For example, if the yen/dollar exchange rate quoted in London at 3 p.m. is ¥120 = $1, the yen/dollar exchange rate quoted in New York at the same time

(10 a.m. New York time) will be identical. If the New York yen/dollar exchange rate were ¥125 = $1, a dealer could make a profit through **arbitrage**, buying a currency low and selling it high. For example, if the prices differed in London and New York as given, a dealer in New York could take $1 million and use that to purchase ¥125 million. She could then immediately sell the ¥125 million for dollars in London, where the transaction would yield $1.041666 million, allowing the trader to book a profit of $41,666 on the transaction. If all dealers tried to cash in on the opportunity, however, the demand for yen in New York would rise, resulting in an appreciation of the yen against the dollar such that the price differential between New York and London would quickly disappear. Because foreign exchange dealers are always watching their computer screens for arbitrage opportunities, the few that arise tend to be small, and they disappear in minutes.

Another feature of the foreign exchange market is the important role played by the U.S. dollar. Although a foreign exchange transaction can involve any two currencies, most transactions involve dollars on one side. This is true even when a dealer wants to sell a nondollar currency and buy another. A dealer wishing to sell Korean won for Brazilian real, for example, will usually sell the won for dollars and then use the dollars to buy real. Although this may seem a roundabout way of doing things, it is actually cheaper than trying to find a holder of real who wants to buy won. Because the volume of international transactions involving dollars is so great, it is not hard to find dealers who wish to trade dollars for won or real.

Due to its central role in so many foreign exchange deals, the dollar is a vehicle currency. In 2010, 85 percent of all foreign exchange transactions involved dollars on one side of the transaction. After the dollar, the most important vehicle currencies were the euro (39 percent), the Japanese yen (19 percent), and the British pound (13 percent)—reflecting the historical importance of these trading entities in the world economy. The euro has replaced the German mark as the world's second most important vehicle currency. The British pound used to be second in importance to the dollar as a vehicle currency, but its importance has diminished in recent years. Despite this, London has retained its leading position in the global foreign exchange market. Despite China's growing importance in international trade, the Chinese renminbi was used in only 0.3 percent of foreign exchange transaction, about the same as the Hungarian forint. The low volume of transactions involving the renminbi reflects the fact that the currency is tied to the value of the U.S. dollar, and as such, its value is not yet determined by market forces, making it an unattractive vehicle currency (see Chapter 11 for more details).

Economic Theories of Exchange Rate Determination

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At the most basic level, exchange rates are determined by the demand and supply of one currency relative to the demand and supply of another. For example, if the demand for dollars outstrips the supply of them and if the supply of Japanese yen is greater than the demand for them, the dollar/yen exchange rate will change. The dollar will appreciate against the yen (or the yen will depreciate against the dollar). However, while differences in relative demand and supply explain the determination of exchange rates, they do so only in a superficial sense. This simple explanation does not reveal what factors underlie the demand for and supply of a currency. Nor does it tell us when the demand for dollars will exceed the supply (and vice versa) or when the supply of Japanese yen will exceed demand for them (and vice versa). Neither does it show under what conditions a currency is in demand or under what conditions it is not demanded. In this section, we will review economic theory's answers to these questions. This will give us a deeper understanding of how exchange rates are determined.

If we understand how exchange rates are determined, we may be able to forecast exchange rate movements. Because future exchange rate movements influence export opportunities, the profitability of international trade and investment deals, and the price

competitiveness of foreign imports, this is valuable information for an international business. Unfortunately, there is no simple explanation. The forces that determine exchange rates are complex, and no theoretical consensus exists, even among academic economists who study the phenomenon every day. Nonetheless, most economic theories of exchange rate movements seem to agree that three factors have an important impact on future exchange rate movements in a country's currency: the country's price inflation, its interest rate, and market psychology.[9]

PRICES AND EXCHANGE RATES

To understand how prices are related to exchange rate movements, we first need to discuss an economic proposition known as the law of one price. Then we will discuss the theory of purchasing power parity (PPP), which links changes in the exchange rate between two countries' currencies to changes in the countries' price levels.

The Law of One Price

The **law of one price** states that in competitive markets free of transportation costs and barriers to trade (such as tariffs), identical products sold in different countries must sell for the same price when their price is expressed in terms of the same currency.[10] For example, if the exchange rate between the British pound and the dollar is £1 = $2.00, a jacket that retails for $80 in New York should sell for £40 in London (since $80/2.00 = £40). Consider what would happen if the jacket cost £30 in London ($60 in U.S. currency). At this price, it would pay a trader to buy jackets in London and sell them in New York (an example of *arbitrage*). The company initially could make a profit of $20 on each jacket by purchasing it for £30 ($60) in London and selling it for $80 in New York (we are assuming away transportation costs and trade barriers). However, the increased demand for jackets in London would raise their price in London, and the increased supply of jackets in New York would lower their price there. This would continue until prices were equalized. Thus, prices might equalize when the jacket cost £35 ($70) in London and $70 in New York (assuming no change in the exchange rate of £1 = $2.00).

Purchasing Power Parity

If the law of one price were true for all goods and services, the purchasing power parity (PPP) exchange rate could be found from any individual set of prices. By comparing the prices of identical products in different currencies, it would be possible to determine the "real" or PPP exchange rate that would exist if markets were efficient. (An **efficient market** has no impediments to the free flow of goods and services, such as trade barriers.)

A less extreme version of the PPP theory states that given relatively efficient markets—that is, markets in which few impediments to international trade exist—the price of a "basket of goods" should be roughly equivalent in each country. To express the PPP theory in symbols, let P$ be the U.S. dollar price of a basket of particular goods and P¥ be the price of the same basket of goods in Japanese yen. The PPP theory predicts that the dollar/yen exchange rate, E$/¥, should be equivalent to:

$$E_{\$/¥} = P_{\$}/P_{¥}$$

Thus, if a basket of goods costs $200 in the United States and ¥20,000 in Japan, PPP theory predicts that the dollar/yen exchange rate should be $200/¥20,000 or $0.01 per Japanese yen (i.e., $1 = ¥100).

Every year, the newsmagazine *The Economist* publishes its own version of the PPP theorem, which it refers to as the "Big Mac Index." *The Economist* has selected McDonald's Big Mac as a proxy for a "basket of goods" because it is produced according to more or less the same recipe in about 120 countries. The Big Mac PPP is the exchange rate that would have hamburgers costing the same in each country. According to

The Economist, comparing a country's actual exchange rate with the one predicted by the PPP theorem based on relative prices of Big Macs is a test of whether a currency is undervalued or not. This is not a totally serious exercise, as *The Economist* admits, but it does provide a useful illustration of the PPP theorem.

Relative currency values according to the Big Mac index for July 22, 2010, are reproduced in Table 10.2. To calculate the index *The Economist* converts the price of a Big Mac in a country into dollars at current exchange rates and divides that by the average price of a Big Mac in America (which was $3.73). According to the PPP theorem, the prices should be the same. If they are not, it implies that the currency is either overvalued against the dollar or undervalued. For example, the average price of a Big Mac in the euro area was $4.33 at the euro/dollar exchange rate prevailing July 22, 2010. Dividing this by the average price of a Big Mac in the United States gives 1.10 (i.e., 4.33/3.73), which suggests that the euro was overvalued by 16 percent against the U.S. dollar.

The next step in the PPP theory is to argue that the exchange rate will change if relative prices change. For example, imagine there is no price inflation in the United States, while prices in Japan are increasing by 10 percent a year. At the beginning of the year, a basket of goods costs $200 in the United States and ¥20,000 in Japan, so the dollar/yen exchange rate, according to PPP theory, should be $1 = ¥100. At the end of the year, the basket of goods still costs $200 in the United States, but it costs ¥22,000 in Japan. PPP theory predicts that the exchange rate should change as a result. More precisely, by the end of the year:

$$E_{\$/¥} = \$200/¥22{,}000$$

Thus, ¥1 = $0.0091 (or $1 = ¥110). Because of 10 percent price inflation, the Japanese yen has depreciated by 10 percent against the dollar. One dollar will buy 10 percent more yen at the end of the year than at the beginning.

Money Supply and Price Inflation

In essence, PPP theory predicts that changes in relative prices will result in a change in exchange rates. Theoretically, a country in which price inflation is running wild should expect to see its currency depreciate against that of countries in which inflation rates are lower. If we can predict what a country's future inflation rate is likely to be, we can also predict how the value of its currency relative to other currencies—its exchange rate—is likely to change. The growth rate of a country's money supply determines its likely future inflation rate.[11] Thus, in theory at least, we can use information about the growth in money supply to forecast exchange rate movements.

Inflation is a monetary phenomenon. It occurs when the quantity of money in circulation rises faster than the stock of goods and services, that is, when the money supply increases faster than output increases. Imagine what would happen if everyone in the country was suddenly given $10,000 by the government. Many people would rush out to spend their extra money on those things they had always wanted—new cars, new furniture, better clothes, and so on. There would be a surge in demand for goods and services. Car dealers, department stores, and other providers of goods and services would respond to this upsurge in demand by raising prices. The result would be price inflation.

A government increasing the money supply is analogous to giving people more money. An increase in the money supply makes it easier for banks to borrow from the government and for individuals and companies to borrow from banks. The resulting increase in credit causes increases in demand for goods and services. Unless the output of goods and services is growing at a rate similar to that of the money supply, the result will be inflation. This relationship has been observed time after time in country after country.

So now we have a connection between the growth in a country's money supply, price inflation, and exchange rate movements. Put simply, *when the growth in a country's money supply is faster than the growth in its output, price inflation is fueled.* The PPP theory tells us that a country with a high inflation rate will see depreciation in its currency exchange

	The Big Mac index				
	Big Mac prices*		Implied PPP† of the dollar	Actual dollar exchange rate July 21st	Under (–)/over (+) valuation against the dollar, %
	in local currency	in dollars			
United States‡	$ 3.73	3.73			
Argentina	Peso 14.0	3.56	3.75	3.93	–5
Australia	A$ 4.35	3.84	1.17	1.13	3
Brazil	Real 8.71	4.91	2.33	1.77	31
Britain	£ 2.29	3.48	1.63§	1.52§	–7
Canada	C$ 4.17	4.00	1.12	1.04	7
Chile	Peso 1,750	3.34	469	524	–10
China	Yuan 13.2	1.95	3.54	6.78	–48
Colombia	Peso 8,200	4.39	2,196	1,868	18
Costa Rica	Colones 2,000	3.83	536	522	3
Czech Republic	Koruna 67.6	3.43	18.1	19.7	–8
Denmark	DK 28.5	4.90	7.63	5.81	31
Egypt	Pound 13.0	2.28	3.48	5.70	–39
Estonia	Kroon 32.0	2.62	8.57	12.2	–30
Euro area**	€ 3.38	4.33	1.10††	1.28††	16
Hong Kong	HK$ 14.8	1.90	3.96	7.77	–49
Hungary	Forint 740	3.33	198	222	–11
Indonesia	Rupiah 22,780	2.51	6,102	9,063	–33
Israel	Shekel 14.9	3,86	3.99	3.86	3
Japan	¥ 320	3.67	85.7	87.2	–2
Latvia	Lats 1.55	2.80	0.42	0.55	–25
Lithuania	Litas 7.30	2.71	1.96	2.69	–27
Malaysia	Ringgit 7.05	2.19	1.89	3.21	–41
Mexico	Peso 32.0	2.50	8,57	12.8	–33
New Zealand	NZ$ 5.00	3.59	1.34	1.39	–4
Norway	Kroner 45.0	7.20	12.1	6.25	93
Pakistan	Rupee 210	2.46	56.3	85.5	–34
Peru	Sol 10.0	3.54	2.68	2.83	–5
Philippines	Peso 102	2.19	27.3	46.5	–41
Poland	Zloty 8.30	2.60	2.22	3.20	–30
Russia	Rouble 71.0	2.33	19.0	30.4	–38
Saudi Arabia	Riyal 10.0	2.67	2.68	3.75	–29
Singapore	S$ 4.23	3.08	1.13	1.37	–18
South Africa	Rand 18.5	2.45	4.94	7.54	–34
South Korea	Won 3,400	2.82	911	1,204	–24
Sri Lanka	Rupee 210	1.86	56.3	113	–50
Sweden	SKr 48.4	6.56	13.0	7.37	76
Switzerland	SFr 6.50	6.19	1.74	1.05	66
Taiwan	NT$ 75.0	2.34	20.1	32.1	–37
Thailand	Baht 70.0	2.17	18.8	32.3	–42
Turkey	Lira 5.95	3.89	1.59	1.53	4
UAE	Dirhams 11.0	2.99	2.95	3.67	–20
Ukraine	Hryvnia 14.5	1.84	3.88	7.90	–51
Uruguay	Peso 79,0	3.74	21.2	21.1	*nil*

TABLE 10.2

The Big Mac Index, July 22, 2010

Source: *The Economist*, http://bigmacindex.org/2010-big-mac-index.html.
*At current exchange rates
†Purchasing-power parity; local price divided by price in United States
‡Average of Atlanta, Chicago, New York and San Francisco §Dollars per pound
**Weighted average of prices in euro area ††Dollars per euro

TABLE 10.3

Macroeconomic Data for Bolivia, April 1984 to October 1985

Source: Juan-Antonio Morales, "Inflation Stabilization in Bolivia," in Inflation Stabilization: The Experience of Israel, Argentina, Brazil, Bolivia, and Mexico, ed. Michael Bruno et al. (Cambridge, MA: MIT Press, 1988).

Month	Money Supply (billions of pesos)	Price Level Relative to 1982 (average = 1)	Exchange Rate (pesos per dollar)
1984			
April	270	21.1	3,576
May	330	31.1	3,512
June	440	32.3	3,342
July	599	34.0	3,570
August	718	39.1	7,038
September	889	53.7	13,685
October	1,194	85.5	15,205
November	1,495	112.4	18,469
December	3,296	180.9	24,515
1985			
January	4,630	305.3	73,016
February	6,455	863.3	141,101
March	9,089	1,078.6	128,137
April	12,885	1,205.7	167,428
May	21,309	1,635.7	272,375
June	27,778	2,919.1	481,756
July	47,341	4,854.6	885,476
August	74,306	8,081.0	1,182,300
September	103,272	12,647.6	1,087,440
October	132,550	12,411.8	1,120,210

rate. In one of the clearest historical examples, in the mid-1980s, Bolivia experienced hyperinflation—an explosive and seemingly uncontrollable price inflation in which money loses value very rapidly. Table 10.3 presents data on Bolivia's money supply, inflation rate, and its peso's exchange rate with the U.S. dollar during the period of hyperinflation. The exchange rate is actually the "black market" exchange rate, as the Bolivian government prohibited converting the peso to other currencies during the period. The data show that the growth in money supply, the rate of price inflation, and the depreciation of the peso against the dollar all moved in step with each other. This is just what PPP theory and monetary economics predict. Between April 1984 and July 1985, Bolivia's money supply increased by 17,433 percent, prices increased by 22,908 percent, and the value of the peso against the dollar fell by 24,662 percent! In October 1985, the Bolivian government instituted a dramatic stabilization plan—which included the introduction of a new currency and tight control of the money supply—and by 1987 the country's annual inflation rate was down to 16 percent.[12]

Another way of looking at the same phenomenon is that an increase in a country's money supply, which increases the amount of currency available, changes the relative demand and supply conditions in the foreign exchange market. If the U.S. money supply is growing more rapidly than U.S. output, dollars will be relatively more plentiful than the currencies of countries where monetary growth is closer to output growth. As a result

of this relative increase in the supply of dollars, the dollar will depreciate on the foreign exchange market against the currencies of countries with slower monetary growth.

Government policy determines whether the rate of growth in a country's money supply is greater than the rate of growth in output. A government can increase the money supply simply by telling the country's central bank to issue more money. Governments tend to do this to finance public expenditure (building roads, paying government workers, paying for defense, etc.). A government could finance public expenditure by raising taxes, but since nobody likes paying more taxes and since politicians do not like to be unpopular, they have a natural preference for expanding the money supply. Unfortunately, there is no magic money tree. The inevitable result of excessive growth in money supply is price inflation. However, this has not stopped governments around the world from expanding the money supply, with predictable results. If an international business is attempting to predict future movements in the value of a country's currency on the foreign exchange market, it should examine that country's policy toward monetary growth. If the government seems committed to controlling the rate of growth in money supply, the country's future inflation rate may be low (even if the current rate is high) and its currency should not depreciate too much on the foreign exchange market. If the government seems to lack the political will to control the rate of growth in money supply, the future inflation rate may be high, which is likely to cause its currency to depreciate. Historically, many Latin American governments have fallen into this latter category, including Argentina, Bolivia, and Brazil. More recently, many of the newly democratic states of Eastern Europe made the same mistake. In late 2010, when the U.S. Federal Reserve decided to promote growth by expanding the U.S. money supply using a technique known as quantitative easing, critics charged that this too would lead to inflation and a decline in the value of the U.S. dollar on foreign exchange markets, but are they right? For a discussion of this, see the accompanying Country Focus.

Empirical Tests of PPP Theory

PPP theory predicts that exchange rates are determined by relative prices, and that changes in relative prices will result in a change in exchange rates. A country in which price inflation is running wild should expect to see its currency depreciate against that of countries with lower inflation rates. This is intuitively appealing, but is it true in practice? There are several good examples of the connection between a country's price inflation and exchange rate position (such as Bolivia). However, extensive empirical testing of PPP theory has yielded mixed results.[14] While PPP theory seems to yield relatively accurate predictions in the long run, it does not appear to be a strong predictor of short-run movements in exchange rates covering time spans of five years or less.[15] In addition, the theory seems to best predict exchange rate changes for countries with high rates of inflation and underdeveloped capital markets. The theory is less useful for predicting short-term exchange rate movements between the currencies of advanced industrialized nations that have relatively small differentials in inflation rates.

The failure to find a strong link between relative inflation rates and exchange rate movements has been referred to as the purchasing power parity puzzle. Several factors may explain the failure of PPP theory to predict exchange rates more accurately.[16] PPP theory assumes away transportation costs and barriers to trade. In practice, these factors are significant and they tend to create significant price differentials between countries. Transportation costs are certainly not trivial for many goods. Moreover, as we saw in Chapter 7, governments routinely intervene in international trade, creating tariff and nontariff barriers to cross-border trade. Barriers to trade limit the ability of traders to use arbitrage to equalize prices for the same product in different countries, which is required for the law of one price to hold. Government intervention in cross-border trade, by violating the assumption of efficient markets, weakens the link between relative price changes and changes in exchange rates predicted by PPP theory.

In addition, the PPP theory may not hold if many national markets are dominated by a handful of multinational enterprises that have sufficient market power to be able to



COUNTRY FOCUS

Quantitative Easing, Inflation, and the U.S. Dollar

In the fall of 2010, the U.S. Federal Reserve decided to expand the U.S. money supply by entering the open market and purchasing $600 billion in U.S. government bonds from bondholders, a technique known as *quantitative easing*. Where did the $600 billion come from? The Fed simply created new bank reserves and used this cash to pay for the bonds. It had, in effect, printed money. The Fed took this action in an attempt to stimulate the U.S. economy, which in the aftermath of the 2008–2009 global financial crisis was struggling with low economic growth and high unemployment rates. The Fed had already tried to stimulate the economy by lowering short-term interest rates, but these were already close to zero, so it decided to lower medium- to longer-term rates; its tool for doing this was to pump $600 billion into the economy, increasing the supply of money and lowering its price, the interest rate.

Critics were quick to attack the Fed's moves. Many claimed that the policy of expanding the money supply would fuel inflation and lead to a decline in the value of the U.S. dollar on the foreign exchange market. Some even called the policy a deliberate attempt by the Fed to debase the value of the U.S. currency, thereby driving down its value and promoting U.S. exports, which if true would be a form of mercantilism.

On closer inspection, however, these charges seem to be unfounded, for two reasons. First, at the time, the core U.S. inflation rate was the lowest in 50 years. In fact, the Fed actually feared the risk of deflation (a persistent fall in prices), which is a very damaging phenomenon. When prices are falling, people hold off their purchases because they know that goods will be cheaper tomorrow than they are today. This can result in a collapse in aggregate demand and high unemployment. The Fed felt that a little inflation, say 2 percent per year, might be a good thing. Second, U.S. economic growth had been weak, unemployment was high, and there was lots of excess productive capacity in the economy. Consequently, if the injection of money into the economy did stimulate demand, this would not translate into price inflation, since the first response of businesses would be to expand output to utilize their excess capacity. Defenders of the Fed argued that the important point, which the critics seemed to be missing, was that expanding the money supply only leads to higher price inflation when unemployment is relatively low and there is not much excess capacity in the economy, a situation that did not exist in the fall of 2010. As for the currency market, its reaction was muted. At the beginning of November 2010, just before the Fed announced its policy, the index value of the dollar against a basket of other major currencies stood at 72.0623. At the end of January 2011 it stood at 72.1482—almost unchanged. In short, currency traders did not seem to be selling off the dollar reflecting worries about high inflation rates.[13]

exercise some influence over prices, control distribution channels, and differentiate their product offerings between nations.[17] In fact, this situation seems to prevail in a number of industries. In the detergent industry, two companies, Unilever and Procter & Gamble, dominate the market in nation after nation. In heavy earthmoving equipment, Caterpillar Inc. and Komatsu are global market leaders. In the market for semiconductor equipment, Applied Materials has a commanding market share lead in almost every important national market. Microsoft dominates the market for personal computer operating systems and applications systems around the world, and so on. In such cases, dominant enterprises may be able to exercise a degree of pricing power, setting different prices in different markets to reflect varying demand conditions. This is referred to as price discrimination. For price discrimination to work, arbitrage must be limited. According to this argument, enterprises with some market power may be able to control distribution channels and therefore limit the unauthorized resale (arbitrage) of products purchased in another national market. They may also be able to limit resale (arbitrage) by differentiating otherwise identical products among nations along some line, such as design or packaging.

For example, even though the version of Microsoft Office sold in China may be less expensive than the version sold in the United States, the use of arbitrage to equalize

prices may be limited because few Americans would want a version that was based on Chinese characters. The design differentiation between Microsoft Office for China and for the United States means that the law of one price would not work for Microsoft Office, even if transportation costs were trivial and tariff barriers between the United States and China did not exist. If the inability to practice arbitrage were widespread enough, it would break the connection between changes in relative prices and exchange rates predicted by the PPP theorem and help explain the limited empirical support for this theory.

Another factor of some importance is that governments also intervene in the foreign exchange market in attempting to influence the value of their currencies. We will look at why and how they do this in Chapter 11. For now, the important thing to note is that governments regularly intervene in the foreign exchange market, and this further weakens the link between price changes and changes in exchange rates. One more factor explaining the failure of PPP theory to predict short-term movements in foreign exchange rates is the impact of investor psychology and other factors on currency purchasing decisions and exchange rate movements. We will discuss this issue in more detail later in this chapter.

INTEREST RATES AND EXCHANGE RATES

Economic theory tells us that interest rates reflect expectations about likely future inflation rates. In countries where inflation is expected to be high, interest rates also will be high, because investors want compensation for the decline in the value of their money. This relationship was first formalized by economist Irvin Fisher and is referred to as the Fisher Effect. The **Fisher Effect** states that a country's "nominal" interest rate (i) is the sum of the required "real" rate of interest (r) and the expected rate of inflation over the period for which the funds are to be lent (I). More formally,

$$i = r + I$$

For example, if the real rate of interest in a country is 5 percent and annual inflation is expected to be 10 percent, the nominal interest rate will be 15 percent. As predicted by the Fisher Effect, a strong relationship seems to exist between inflation rates and interest rates.[18]

We can take this one step further and consider how it applies in a world of many countries and unrestricted capital flows. When investors are free to transfer capital between countries, real interest rates will be the same in every country. If differences in real interest rates did emerge between countries, arbitrage would soon equalize them. For example, if the real interest rate in Japan was 10 percent and only 6 percent in the United States, it would pay investors to borrow money in the United States and invest it in Japan. The resulting increase in the demand for money in the United States would raise the real interest rate there, while the increase in the supply of foreign money in Japan would lower the real interest rate there. This would continue until the two sets of real interest rates were equalized.

It follows from the Fisher Effect that if the real interest rate is the same worldwide; any difference in interest rates between countries reflects differing expectations about inflation rates. Thus, if the expected rate of inflation in the United States is greater than that in Japan, U.S. nominal interest rates will be greater than Japanese nominal interest rates.

Since we know from PPP theory that there is a link (in theory at least) between inflation and exchange rates, and since interest rates reflect expectations about inflation, it follows that there must also be a link between interest rates and exchange rates. This link is known as the International Fisher Effect (IFE). The **International Fisher Effect** states that for any two countries, the spot exchange rate should change in an equal amount but in the opposite direction to the difference in nominal interest rates between

the two countries. Stated more formally, the change in the spot exchange rate between the United States and Japan, for example, can be modeled as follows:

$$[(S_1 - S_2)/S_2] \times 100 = i_{\$} - i_{¥}$$

where $i_{\$}$ and $i_{¥}$ are the respective nominal interest rates in the United States and Japan, S_1 is the spot exchange rate at the beginning of the period, and S_2 is the spot exchange rate at the end of the period. If the U.S. nominal interest rate is higher than Japan's, reflecting greater expected inflation rates, the value of the dollar against the yen should fall by that interest rate differential in the future. So if the interest rate in the United States is 10 percent and in Japan it is 6 percent, we would expect the value of the dollar to depreciate by 4 percent against the Japanese yen.

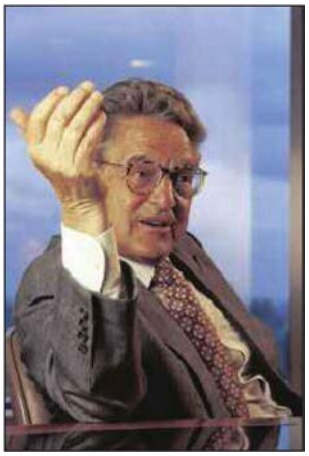
Do interest rate differentials help predict future currency movements? The evidence is mixed; as in the case of PPP theory, in the long run, there seems to be a relationship between interest rate differentials and subsequent changes in spot exchange rates. However, considerable short-run deviations occur. Like PPP, the International Fisher Effect is not a good predictor of short-run changes in spot exchange rates.[19]

INVESTOR PSYCHOLOGY AND BANDWAGON EFFECTS

Empirical evidence suggests that neither PPP theory nor the International Fisher Effect is particularly good at explaining short-term movements in exchange rates. One reason may be the impact of investor psychology on short-run exchange rate movements. Evidence reveals that various psychological factors play an important role in determining the expectations of market traders as to likely future exchange rates.[20] In turn, expectations have a tendency to become self-fulfilling prophecies.

A famous example of this mechanism occurred in September 1992 when the international financier George Soros made a huge bet against the British pound. Soros borrowed billions of pounds, using the assets of his investment funds as collateral, and immediately sold those pounds for German deutsche marks (this was before the advent of the euro). This technique, known as short selling, can earn the speculator enormous profits if he can subsequently buy back the pounds he sold at a much better exchange rate, and then use those pounds, purchased cheaply, to repay his loan. By selling pounds and buying deutsche marks, Soros helped to start pushing down the value of the pound on the foreign exchange markets. More importantly, when Soros started shorting the British pound, many foreign exchange traders, knowing Soros's reputation, jumped on the bandwagon and did likewise. This triggered a classic **bandwagon effect** with traders moving as a herd in the same direction at the same time. As the bandwagon effect gained momentum, with more traders selling British pounds and purchasing deutsche marks in expectation of a decline in the pound, their expectations became a self-fulfilling prophecy. Massive selling forced down the value of the pound against the deutsche mark. In other words, the pound declined in value not so much because of any major shift in macroeconomic fundamentals, but because investors followed a bet placed by a major speculator, George Soros.

According to a number of studies, investor psychology and bandwagon effects play a major role in determining short-run exchange rate movements.[21] However, these effects can be hard to predict. Investor psychology can be influenced by political factors and by microeconomic events, such as the investment decisions of individual firms, many of which are only loosely linked to macroeconomic fundamentals, such as relative inflation rates. Also, bandwagon effects can be both triggered and exacerbated by the idiosyncratic behavior of politicians. Something like this seems to have occurred in Southeast Asia during 1997 when, one after another, the currencies of Thailand, Malaysia, South Korea, and Indonesia lost between 50 percent and 70 percent of their value against the U.S. dollar in a few months.



George Soros, whose Quantum Fund has been very successful in managing hedge funds, has been criticized by world leaders because his actions can cause huge changes in currency markets.

SUMMARY

Relative monetary growth, relative inflation rates, and nominal interest rate differentials are all moderately good predictors of long-run changes in exchange rates. They are poor predictors of short-run changes in exchange rates, however, perhaps because of the impact of psychological factors, investor expectations, and bandwagon effects on short-term currency movements. This information is useful for an international business. Insofar as the long-term profitability of foreign investments, export opportunities, and the price competitiveness of foreign imports are all influenced by long-term movements in exchange rates, international businesses would be advised to pay attention to countries' differing monetary growth, inflation, and interest rates. International businesses that engage in foreign exchange transactions on a day-to-day basis could benefit by knowing some predictors of short-term foreign exchange rate movements. Unfortunately, short-term exchange rate movements are difficult to predict.

LO5 Exchange Rate Forecasting

A company's need to predict future exchange rate variations raises the issue of whether it is worthwhile for the company to invest in exchange rate forecasting services to aid decision making. Two schools of thought address this issue. The efficient market school argues that forward exchange rates do the best possible job of forecasting future spot exchange rates, and, therefore, investing in forecasting services would be a waste of money. The other school of thought, the inefficient market school, argues that companies can improve the foreign exchange market's estimate of future exchange rates (as contained in the forward rate) by investing in forecasting services. In other words, this school of thought does not believe the forward exchange rates are the best possible predictors of future spot exchange rates.

THE EFFICIENT MARKET SCHOOL

Forward exchange rates represent market participants' collective predictions of likely spot exchange rates at specified future dates. If forward exchange rates are the best possible predictor of future spot rates, it would make no sense for companies to spend additional money trying to forecast short-run exchange rate movements. Many economists believe the foreign exchange market is efficient at setting forward rates.[22] An **efficient market** is one in which prices reflect all available public information. (If forward rates reflect all available information about likely future changes in exchange rates, a company cannot beat the market by investing in forecasting services.)

If the foreign exchange market is efficient, forward exchange rates should be unbiased predictors of future spot rates. This does not mean the predictions will be accurate in any specific situation. It means inaccuracies will not be consistently above or below future spot rates; they will be random. Many empirical tests have addressed the efficient market hypothesis. Although most of the early work seems to confirm the hypothesis (suggesting that companies should not waste their money on forecasting services) some recent studies have challenged it.[23] There is some evidence that forward rates are not unbiased predictors of future spot rates, and that more accurate predictions of future spot rates can be calculated from publicly available information.[24]

THE INEFFICIENT MARKET SCHOOL

Citing evidence against the efficient market hypothesis, some economists believe the foreign exchange market is inefficient. An **inefficient market** is one in which prices do not reflect all available information. In an inefficient market, forward exchange rates will not be the best possible predictors of future spot exchange rates.

If this is true, it may be worthwhile for international businesses to invest in forecasting services (as many do). The belief is that professional exchange rate forecasts might

provide better predictions of future spot rates than forward exchange rates do. However, the track record of professional forecasting services is not that good.[25] For example, forecasting services did not predict the 1997 currency crisis that swept through Southeast Asia, nor did they predict the rise in the value of the dollar that occurred during late 2008, a period when the United States fell into a deep financial crisis that some thought would lead to a decline in the value of the dollar (it appears that the dollar rose because it was seen as a relatively safe currency in a time when many nations were experiencing economic trouble).

APPROACHES TO FORECASTING

Assuming the inefficient market school is correct that the foreign exchange market's estimate of future spot rates can be improved, on what basis should forecasts be prepared? Here again, there are two schools of thought. One adheres to fundamental analysis, while the other uses technical analysis.

Fundamental Analysis

Fundamental analysis draws on economic theory to construct sophisticated econometric models for predicting exchange rate movements. The variables contained in these models typically include those we have discussed, such as relative money supply growth rates, inflation rates, and interest rates. In addition, they may include variables related to balance-of-payments positions.

Running a deficit on a balance-of-payments current account (a country is importing more goods and services than it is exporting) creates pressures that may result in the depreciation of the country's currency on the foreign exchange market.[26] Consider what might happen if the United States was running a persistent current account balance-of-payments deficit (as it has been). Since the United States would be importing more than it was exporting, people in other countries would be increasing their holdings of U.S. dollars. If these people were willing to hold their dollars, the dollar's exchange rate would not be influenced. However, if these people converted their dollars into other currencies, the supply of dollars in the foreign exchange market would increase (as would demand for the other currencies). This shift in demand and supply would create pressures that could lead to the depreciation of the dollar against other currencies.

This argument hinges on whether people in other countries are willing to hold dollars. This depends on such factors as U.S. interest rates, the return on holding other dollar-denominated assets such as stocks in U.S. companies, and, most importantly, inflation rates. So, in a sense, the balance-of-payments situation is not a fundamental predictor of future exchange rate movements. For example, between 1998 and 2001, the U.S. dollar appreciated against most major currencies despite a growing balance-of-payments deficit. Relatively high real interest rates in the United States, coupled with low inflation and a booming U.S. stock market that attracted inward investment from foreign capital, made the dollar very attractive to foreigners, so they did not convert their dollars into other currencies. On the contrary, they converted other currencies into dollars to invest in U.S. financial assets, such as bonds and stocks, because they believed they could earn a high return by doing so. Capital flows into the United States fueled by foreigners who wanted to buy U.S. stocks and bonds kept the dollar strong despite the current account deficit. But what makes financial assets such as stocks and bonds attractive? The answer is prevailing interest rates and inflation rates, both of which affect underlying economic growth and the real return to holding U.S. financial assets. Given this, we are back to the argument that the fundamental determinants of exchange rates are monetary growth, inflation rates, and interest rates.

Technical Analysis

Technical analysis uses price and volume data to determine past trends, which are expected to continue into the future. This approach does not rely on a consideration of

economic fundamentals. Technical analysis is based on the premise that there are analyzable market trends and waves and that previous trends and waves can be used to predict future trends and waves. Since there is no theoretical rationale for this assumption of predictability, many economists compare technical analysis to fortune-telling. Despite this skepticism, technical analysis has gained favor in recent years.[27]

Currency Convertibility

Until this point we have invalidly assumed that the currencies of various countries are freely convertible into other currencies. Due to government restrictions, a significant number of currencies are not freely convertible into other currencies. A country's currency is said to be **freely convertible** when the country's government allows both residents and nonresidents to purchase unlimited amounts of a foreign currency with it. A currency is said to be **externally convertible** when only nonresidents may convert it into a foreign currency without any limitations. A currency is **nonconvertible** when neither residents nor nonresidents are allowed to convert it into a foreign currency.

Free convertibility is not universal. Many countries place some restrictions on their residents' ability to convert the domestic currency into a foreign currency (a policy of external convertibility). Restrictions range from the relatively minor (such as restricting the amount of foreign currency they may take with them out of the country on trips) to the major (such as restricting domestic businesses' ability to take foreign currency out of the country). External convertibility restrictions can limit domestic companies' ability to invest abroad, but they present few problems for foreign companies wishing to do business in that country. For example, even if the Japanese government tightly controlled the ability of its residents to convert the yen into U.S. dollars, all U.S. businesses with deposits in Japanese banks may at any time convert all their yen into dollars and take them out of the country. Thus, a U.S. company with a subsidiary in Japan is assured that it will be able to convert the profits from its Japanese operation into dollars and take them out of the country.

Serious problems arise, however, under a policy of nonconvertibility. This was the practice of the former Soviet Union, and it continued to be the practice in Russia for several years after the collapse of the Soviet Union. When strictly applied, nonconvertibility means that although a U.S. company doing business in a country such as Russia may be able to generate significant ruble profits, it may not convert those rubles into dollars and take them out of the country. Obviously this is not desirable for international business.

Governments limit convertibility to preserve their foreign exchange reserves. A country needs an adequate supply of these reserves to service its international debt commitments and to purchase imports. Governments typically impose convertibility restrictions on their currency when they fear that free convertibility will lead to a run on their foreign exchange reserves. This occurs when residents and nonresidents rush to convert their holdings of domestic currency into a foreign currency—a phenomenon generally referred to as **capital flight**. Capital flight is most likely to occur when the value of the domestic currency is depreciating rapidly because of hyperinflation, or when a country's economic prospects are shaky in other respects. Under such circumstances, both residents and nonresidents tend to believe that their money is more likely to hold its value if it is converted into a foreign currency and invested abroad. Not only will a run on foreign exchange reserves limit the country's ability to service its international debt and pay for imports, but it will also lead to a precipitous depreciation in the exchange rate as residents and nonresidents unload their holdings of domestic currency on the foreign exchange markets (thereby increasing the market supply of the country's currency). Governments fear that the rise in import prices resulting from currency depreciation will lead to further increases in inflation. This fear provides another rationale for limiting convertibility.

Companies can deal with the nonconvertibility problem by engaging in countertrade. **Countertrade** refers to a range of barter-like agreements by which goods and services can be traded for other goods and services. Countertrade can make sense when a country's currency is nonconvertible. For example, consider the deal that General Electric struck with the Romanian government when that country's currency was nonconvertible. When General Electric won a contract for a $150 million generator project in Romania, it agreed to take payment in the form of Romanian goods that could be sold for $150 million on international markets. In a similar case, the Venezuelan government negotiated a contract with Caterpillar under which Venezuela would trade 350,000 tons of iron ore for Caterpillar heavy construction equipment. Caterpillar subsequently traded the iron ore to Romania in exchange for Romanian farm products, which it then sold on international markets for dollars.[28] Similarly, in a 2003 deal the government of Indonesia entered into a countertrade with Libya under which Libya agreed to purchase $540 million in Indonesian goods, including textiles, tea, coffee, electronics, plastics, and auto parts, in exchange for 50,000 barrels per day of Libyan crude oil.[29]

How important is countertrade? Twenty years ago, a large number of nonconvertible currencies existed in the world, and countertrade was quite significant. However, in recent years many governments have made their currencies freely convertible, and the percentage of world trade that involves countertrade is probably significantly below 10 percent.[30]

IMPLICATIONS FOR MANAGERS



LO6

This chapter contains a number of clear implications for business. First, it is critical that international businesses understand the influence of exchange rates on the profitability of trade and investment deals. Adverse changes in exchange rates can make apparently profitable deals unprofitable. As noted, the risk introduced into international business transactions by changes in exchange rates is referred to as foreign exchange risk. Foreign exchange risk is usually divided into three main categories: transaction exposure, translation exposure, and economic exposure.

TRANSACTION EXPOSURE

Transaction exposure is the extent to which the income from individual transactions is affected by fluctuations in foreign exchange values. Such exposure includes obligations for the purchase or sale of goods and services at previously agreed prices and the borrowing or lending of funds in foreign currencies. For example, suppose in 2004 an American airline agreed to purchase 10 Airbus 330 aircraft for €120 million each for a total price of €1.20 billion, with delivery scheduled for 2005 and payment due then. When the contract was signed in 2004 the dollar/euro exchange rate stood at $1 = €1.10 so the American airline anticipated paying $1 billion for the 10 aircraft when they were delivered (€1.2 billion/1.1 = $1.09 billion). However, imagine that the value of the dollar depreciates against the euro over the intervening period, so that one dollar only buys €0.80 in 2008 when payment is due ($1 = €0.80). Now the total cost in U.S. dollars is $1.5 billion (€1.2 billion/0.80 = $1.5 billion), an increase of $0.41 billion! The transaction exposure here is $0.41 billion, which is the money lost due to an adverse movement in exchange rates between the time when the deal was signed and when the aircraft were paid for.

TRANSLATION EXPOSURE

Translation exposure is the impact of currency exchange rate changes on the reported financial statements of a company. Translation exposure is concerned with the present measurement of past events. The resulting accounting gains or losses are said to be

unrealized—they are "paper" gains and losses—but they are still important. Consider a U.S. firm with a subsidiary in Mexico. If the value of the Mexican peso depreciates significantly against the dollar this would substantially reduce the dollar value of the Mexican subsidiary's equity. In turn, this would reduce the total dollar value of the firm's equity reported in its consolidated balance sheet. This would raise the apparent leverage of the firm (its debt ratio), which could increase the firm's cost of borrowing and potentially limit its access to the capital market. Similarly, if an American firm has a subsidiary in the European Union, and if the value of the euro depreciates rapidly against that of the dollar over a year, this will reduce the dollar value of the euro profit made by the European subsidiary, resulting in negative translation exposure. In fact, many U.S. firms suffered from significant negative translation exposure in Europe during 2000, precisely because the euro did depreciate rapidly against the dollar. In 2002–2007, the euro rose in value against the dollar. This positive translation exposure boosted the dollar profits of American multinationals with significant operations in Europe.

ECONOMIC EXPOSURE

Economic exposure is the extent to which a firm's future international earning power is affected by changes in exchange rates. Economic exposure is concerned with the long-run effect of changes in exchange rates on future prices, sales, and costs. This is distinct from transaction exposure, which is concerned with the effect of exchange rate changes on individual transactions, most of which are short-term affairs that will be executed within a few weeks or months. Consider the effect of wide swings in the value of the dollar on many U.S. firms' international competitiveness. The rapid rise in the value of the dollar on the foreign exchange market in the 1990s hurt the price competitiveness of many U.S. producers in world markets. U.S. manufacturers that relied heavily on exports (such as Caterpillar) saw their export volume and world market share decline. The reverse phenomenon occurred in 2000–2009, when the dollar declined against most major currencies. The fall in the value of the dollar helped increase the price competitiveness of U.S. manufacturers in world markets.

REDUCING TRANSLATION AND TRANSACTION EXPOSURE

A number of tactics can help firms minimize their transaction and translation exposure. These tactics primarily protect short-term cash flows from adverse changes in exchange rates. We have already discussed two of these tactics at length in the chapter, entering into forward exchange rate contracts and buying swaps. In addition to buying forward and using swaps, firms can minimize their foreign exchange exposure through leading and lagging payables and receivables—that is, paying suppliers and collecting payment from customers early or late depending on expected exchange rate movements. A **lead strategy** involves attempting to collect foreign currency receivables (payments from customers) early when a foreign currency is expected to depreciate and paying foreign currency payables (to suppliers) before they are due when a currency is expected to appreciate. A **lag strategy** involves delaying collection of foreign currency receivables if that currency is expected to appreciate and delaying payables if the currency is expected to depreciate. Leading and lagging involve accelerating payments from weak-currency to strong-currency countries and delaying inflows from strong-currency to weak-currency countries.

Lead and lag strategies can be difficult to implement, however. The firm must be in a position to exercise some control over payment terms. Firms do not always have this kind of bargaining power, particularly when they are dealing with important customers who are in a position to dictate payment terms. Also, because lead and lag strategies can put pressure on a weak currency, many governments limit leads and lags. For example, some countries set 180 days as a limit for receiving payments for exports or making payments for imports.

MANAGEMENT FOCUS

Dealing with the Rising Euro

Udo Pfeiffer, the CEO of SMS Elotherm, a German manufacturer of machine tools to engineer crankshafts for cars, signed a deal in late November 2004 to supply the U.S. operations of DaimlerChrysler with $1.5 million worth of machines. The machines would be manufactured in Germany and exported to the United States. When the deal was signed, Pfeiffer calculated that at the agreed price, the machines would yield a profit of €30,000 each. Within three days that profit had declined by €8,000! The dollar had slid precipitously against the euro. SMS would be paid in dollars by DaimlerChrysler, but when translated back into euros, the price had declined. Since the company's costs were in euros, the declining revenues when expressed in euros were squeezing profit margins.

With the exchange rate standing at €1 = $1.33 in early December 2004, Pfeiffer was deeply worried. He knew that if the dollar declined further to around €1 = $1.50, SMS would be losing money on its sales to America. He could try to raise the dollar price of his products to compensate for the fall in the value of the dollar, but he knew that was unlikely to work. The market for machine tools was very competitive, and manufacturers were constantly pressuring machine tool companies to lower prices, not raise them.

Another small German supplier to U.S. automobile companies, Keiper, was faring somewhat better. In 2001 Keiper, which manufactures metal frames for automobile seats, opened a plant in London, Ontario, to supply the U.S. operations of DaimlerChrysler. At the time the investment was made, the exchange rate was €1 = $1. Management at Keiper had agonized over whether the investment made sense. Some in the company believed it was better to continue exporting from Germany. Others argued that Keiper would benefit from being close to a major customer. Now with the euro appreciating every day, it looked like a smart move. Keiper had a real hedge against the rising value of the euro. But the advantages of being based in Canada were tempered by two things; first, the U.S. dollar had also depreciated against the Canadian dollar, although not by as much as its depreciation against the euro. Second, Keiper was still importing parts from Germany, and the euro had also appreciated against the Canadian dollar, raising the costs at Keiper's Ontario plant.[31]

REDUCING ECONOMIC EXPOSURE

Reducing economic exposure requires strategic choices that go beyond the realm of financial management. The key to reducing economic exposure is to distribute the firm's productive assets to various locations so the firm's long-term financial well-being is not severely affected by adverse changes in exchange rates. This is a strategy that firms both large and small sometimes pursue. For example, fearing that the euro will continue to strengthen against the U.S. dollar, some European firms that do significant business in the United States have set up local production facilities in that market to ensure that a rising euro does not put them at a competitive disadvantage relative to their local rivals. Similarly, Toyota has production plants distributed around the world in part to make sure that a rising yen does not price Toyota cars out of local markets. Caterpillar, detailed in the closing case, has also pursued this strategy, setting up factories around the world that can act as a hedge against the possibility that a strong dollar will price Caterpillar's exports out of foreign markets. In 2008 and 2009, this real hedge proved to be very useful. The accompanying Management Focus discusses how two German firms tried to reduce economic exposure.

OTHER STEPS FOR MANAGING FOREIGN EXCHANGE RISK

A firm needs to develop a mechanism for ensuring it maintains an appropriate mix of tactics and strategies for minimizing its foreign exchange exposure. Although there is no universal agreement as to the components of this mechanism, a number of common

themes stand out.[32] First, central control of exposure is needed to protect resources efficiently and ensure that each subunit adopts the correct mix of tactics and strategies. Many companies have set up in-house foreign exchange centers. Although such centers may not be able to execute all foreign exchange deals—particularly in large, complex multinationals where myriad transactions may be pursued simultaneously— they should at least set guidelines for the firm's subsidiaries to follow.

Second, firms should distinguish between, on one hand, transaction and translation exposure and, on the other, economic exposure. Many companies seem to focus on reducing their transaction and translation exposure and pay scant attention to economic exposure, which may have more profound long-term implications.[33] Firms need to develop strategies for dealing with economic exposure. For example, Black & Decker, the maker of power tools, has a strategy for actively managing its economic risk. The key to Black & Decker's strategy is flexible sourcing. In response to foreign exchange movements, Black & Decker can move production from one location to another to offer the most competitive pricing. Black & Decker manufactures in more than a dozen locations around the world—in Europe, Australia, Brazil, Mexico, and Japan. More than 50 percent of the company's productive assets are based outside North America. Although each of Black & Decker's factories focuses on one or two products to achieve economies of scale, there is considerable overlap. On average, the company runs its factories at no more than 80 percent capacity, so most are able to switch rapidly from producing one product to producing another or to add a product. This allows a factory's production to be changed in response to foreign exchange movements. For example, if the dollar depreciates against other currencies, the amount of imports into the United States from overseas subsidiaries can be reduced and the amount of exports from U.S. subsidiaries to other locations can be increased.[34]

Third, the need to forecast future exchange rate movements cannot be overstated, though, as we saw earlier in the chapter, this is a tricky business. No model comes close to perfectly predicting future movements in foreign exchange rates. The best that can be said is that in the short run, forward exchange rates provide the best predictors of exchange rate movements, and in the long run, fundamental economic factors— particularly relative inflation rates—should be watched because they influence exchange rate movements. Some firms attempt to forecast exchange rate movements in-house; others rely on outside forecasters. However, all such forecasts are imperfect attempts to predict the future.

Fourth, firms need to establish good reporting systems so the central finance function (or in-house foreign exchange center) can regularly monitor the firm's exposure positions. Such reporting systems should enable the firm to identify any exposed accounts, the exposed position by currency of each account, and the time periods covered.

Finally, on the basis of the information it receives from exchange rate forecasts and its own regular reporting systems, the firm should produce monthly foreign exchange exposure reports. These reports should identify how cash flows and balance sheet elements might be affected by forecasted changes in exchange rates. The reports can then be used by management as a basis for adopting tactics and strategies to hedge against undue foreign exchange risks.

Surprisingly, some of the largest and most sophisticated firms don't take such precautionary steps, exposing themselves to very large foreign exchange risks. Thus, as we have seen in this chapter, Volkswagen suffered significant losses during the early 2000s due to a failure to adequately hedge its foreign exchange exposure.

CHAPTER SUMMARY

This chapter explained how the foreign exchange market works, examined the forces that determine exchange rates, and then discussed the implications of these factors for international business. Given that changes in exchange rates can dramatically alter the profitability of foreign trade and investment deals, this is an area of major interest to international business. The chapter made the following points:

1. One function of the foreign exchange market is to convert the currency of one country into the currency of another. A second function of the foreign exchange market is to provide insurance against foreign exchange risk.
2. The spot exchange rate is the exchange rate at which a dealer converts one currency into another currency on a particular day.
3. Foreign exchange risk can be reduced by using forward exchange rates. A forward exchange rate is an exchange rate governing future transactions. Foreign exchange risk can also be reduced by engaging in currency swaps. A swap is the simultaneous purchase and sale of a given amount of foreign exchange for two different value dates.
4. The law of one price holds that in competitive markets that are free of transportation costs and barriers to trade, identical products sold in different countries must sell for the same price when their price is expressed in the same currency.
5. Purchasing power parity (PPP) theory states the price of a basket of particular goods should be roughly equivalent in each country. PPP theory predicts that the exchange rate will change if relative prices change.
6. The rate of change in countries' relative prices depends on their relative inflation rates. A country's inflation rate seems to be a function of the growth in its money supply.
7. The PPP theory of exchange rate changes yields relatively accurate predictions of long-term trends in exchange rates, but not of short-term movements. The failure of PPP theory to predict exchange rate changes more accurately may be due to transportation costs, barriers to trade and investment, and the impact of psychological factors such as bandwagon effects on market movements and short-run exchange rates.
8. Interest rates reflect expectations about inflation. In countries where inflation is expected to be high, interest rates also will be high.
9. The International Fisher Effect states that for any two countries, the spot exchange rate should change in an equal amount but in the opposite direction to the difference in nominal interest rates.
10. The most common approach to exchange rate forecasting is fundamental analysis. This relies on variables such as money supply growth, inflation rates, nominal interest rates, and balance-of-payments positions to predict future changes in exchange rates.
11. In many countries, the ability of residents and nonresidents to convert local currency into a foreign currency is restricted by government policy. A government restricts the convertibility of its currency to protect the country's foreign exchange reserves and to halt any capital flight.
12. Problematic for international business is a policy of nonconvertibility, which prohibits residents and nonresidents from exchanging local currency for foreign currency. Nonconvertibility makes it very difficult to engage in international trade and investment in the country. One way of coping with the nonconvertibility problem is to engage in countertrade—to trade goods and services for other goods and services.
13. The three types of exposure to foreign exchange risk are transaction exposure, translation exposure, and economic exposure.
14. Tactics that insure against transaction and translation exposure include buying forward, using currency swaps, and leading and lagging payables and receivables.
15. Reducing a firm's economic exposure requires strategic choices about how the firm's productive assets are distributed around the globe.
16. To manage foreign exchange exposure effectively, the firm must exercise centralized oversight over its foreign exchange hedging activities, recognize the difference between transaction exposure and economic exposure, forecast future exchange rate movements, establish good reporting systems within the firm to monitor exposure positions, and produce regular foreign exchange exposure reports that can be used as a basis for action.

Critical Thinking and Discussion Questions

1. The interest rate on South Korean government securities with one-year maturity is 4 percent, and the expected inflation rate for the coming year is 2 percent. The interest rate on U.S. government securities with one-year maturity is 7 percent, and the expected rate of inflation is 5 percent. The current spot exchange rate for Korean won is $1 = W1,200. Forecast the spot exchange rate one year from today. Explain the logic of your answer.
2. Two countries, Great Britain and the United States, produce just one good: beef. Suppose the price of beef in the United States is $2.80 per pound and in Britain it is £3.70 per pound.
   a. According to PPP theory, what should the dollar/pound spot exchange rate be?
   b. Suppose the price of beef is expected to rise to $3.10 in the United States and to £4.65 in Britain. What should the one-year forward dollar/pound exchange rate be?
   c. Given your answers to parts a and b, and given that the current interest rate in the United States is 10 percent, what would you expect the current interest rate to be in Britain?
3. Reread the Management Focus on Volkswagen, then answer the following questions:
   a. Why do you think management at Volkswagen decided to hedge only 30 percent of the automaker's foreign currency exposure in 2003? What would have happened if it had hedged 70 percent of exposure?
   b. Why do you think the value of the U.S. dollar declined against that of the euro in 2003?
   c. Apart from hedging through the foreign exchange market, what else can Volkswagen do to reduce its exposure to future declines in the value of the U.S. dollar against the euro?
4. You manufacture wine goblets. In mid-June you receive an order for 10,000 goblets from Japan. Payment of ¥400,000 is due in mid-December. You expect the yen to rise from its present rate of $1 = ¥130 to $1 = ¥100 by December. You can borrow yen at 6 percent a year. What should you do?
5. You are the CFO of a U.S. firm whose wholly owned subsidiary in Mexico manufactures component parts for your U.S. assembly operations. The subsidiary has been financed by bank borrowings in the United States. One of your analysts told you that the Mexican peso is expected to depreciate by 30 percent against the dollar on the foreign exchange markets over the next year. What actions, if any, should you take?

Research Task globalEDGE globaledge.msu.edu

The Foreign Exchange Market

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

One component of learning about another country or region is to understand the relationship of its currency with others on the world currency market. As such, you are assigned the duty of ensuring the availability of 1,000,000 yen for a payment scheduled for next month. Considering that your company possesses only US dollars, identify the spot and forward *exchange rates*. What are the factors that influence your decision to use each? Which one would you choose? How many dollars must you spend to acquire the amount of yen required?

Exercise 2

Sometimes, analysts use the price of specific products in different locations to compare currency valuation and purchasing power. For example, the *Big Mac Index* compares the purchasing power parity of many countries based on the price of a Big Mac. Locate the latest edition of this index that is accessible. Identify the five countries (and their currencies) with the lowest purchasing power parity according to this classification. Which currencies, if any, are overvalued?

CLOSING CASE

Caterpillar

Caterpillar has long been one of America's major exporters. The company sells its construction equipment, mining equipment, and engines to some 200 countries worldwide. As a leading exporter, Caterpillar's fate has often been tied to the value of the U.S. dollar. In the 1980s, the U.S. dollar was strong against the Japanese yen. This gave Komatsu, Japan's premier manufacturer of heavy construction equipment, a pricing advantage against Caterpillar. Undercutting Caterpillar's prices by as much as 30 percent, Komatsu grabbed market share in the United States and other markets. For Caterpillar, it was a difficult time. At one point the company was losing a million dollars a day and battling a hostile labor union that was opposed to job restructuring designed to make the company more competitive. The company seemed to be yet another example of a declining business in America's Rust Belt.

Fast forward to the mid-2000s, and Caterpillar was thriving. Much had changed over the previous two decades. Caterpillar had reached deals with its unions and invested in state-of-the-art manufacturing facilities. Its productivity, once abysmal, was now among the best in the industry. Sales, exports, and profits were all rising. There was a worldwide boom in spending on infrastructure, and Caterpillar was reaping the gains, producing record amounts of equipment. Plus, the U.S. dollar, which for years had been strong, weakened significantly during the mid-2000s. This reduced the price of Caterpillar's exports, when translated into many foreign currencies. At this point, Caterpillar was exporting more than half of the output of its key U.S. factories near Peoria, Illinois.

Then in 2008, the dollar started to strengthen again. Even though the American economy was stumbling into a financial crisis that would usher in a steep economic recession, foreigners invested strongly in U.S. assets, particularly Treasury bills. Their demand for dollars to purchase these assets pushed up the value of the dollar on the foreign exchange markets. The hunger of foreigners for dollars was based on a belief that even though things were bad in America, they were probably going to be even worse in many other developed economies, and the U.S. government at least would not default on its bonds, making U.S. Treasury bills a safe haven in an economic storm.

Analysts fretted that the stronger dollar would hurt Caterpillar's financial performance because the prices of its exports were rising when converted into many foreign currencies. The reality, however, was somewhat different.

As 2008 progressed, the strong dollar started to negatively impact Caterpillar's revenues, but it had a *favorable* effect on Caterpillar's costs. Over the previous two decades Caterpillar had dramatically expanded its network of foreign manufacturing operations. While still a major exporter, some 102 of its 237 manufacturing facilities were now located outside of North America, many in countries such as China, India, and Brazil that were expanding their infrastructure spending. Although the revenues generated by these operations in local currency, when translated back into dollars, declined as the dollar strengthened, the costs of these operations also fell, since their costs were also priced in local currencies, which reduced the impact on profit margins. Also, although Caterpillar's export revenues from the United States started to fall, because the company now sourced many of its inputs from foreign producers, the price it paid for those inputs also fell, which again moderated the impact of the strong dollar on earnings. Through its globalization strategy, Caterpillar has been able to reduce the impact of fluctuations in the value of the dollar on its profits.[35]

Case Discussion Questions

1. In the 1980s a stronger dollar hurt Caterpillar's competitive position, but in 2008 a stronger dollar did not seem to have the same effect. What had changed?
2. How did Caterpillar use strategy as a "real hedge" to reduce its exposure to foreign exchange risk? What is the downside of its approach?
3. Explain the difference between transaction exposure and translation exposure using the material in the Caterpillar case to illustrate your answer.

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11 The International Monetary System

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Describe the historical development of the modern global monetary system.
- **LO2** Explain the role played by the World Bank and the IMF in the international monetary system.
- **LO3** Compare and contrast the differences between a fixed and a floating exchange rate system.
- **LO4** Identify exchange rate regimes used in the world today and why countries adopt different exchange rate regimes.
- **LO5** Understand the debate surrounding the role of the IMF in the management of financial crises.
- **LO6** Explain the implications of the global monetary system for currency management and business strategy.

Ireland's Debt Crisis

For much of the 1990s and early 2000s the Irish economy was heralded as one of the European Union's great success stories. Once one of the poorest countries in Western Europe known primarily for the export of its people, Ireland achieved rapid economic growth after it joined the European Union. With low corporate tax rates, an educated and productive work force, and a pro-business government, Ireland attracted significant foreign direct investment from high-tech companies, including Intel and Microsoft, which used the nation as their base for serving the rest of the EU. From 1987 to 2000 annual economic growth averaged 6.8 percent and unemployment fell from 16.9 percent to 4.3 percent. When Ireland adopted the euro as its currency in 1999, many thought this would strengthen its position within Europe.

Alas, it was not to be. Somewhere along the way strong economic growth gave way to a housing bubble, which created the illusion of continued prosperity. Between 1996 and 2006, home prices in Ireland almost quadrupled. Construction spending went from 11 percent to 21 percent of the economy. Everyone seemed to be getting rich. Encouraged by rising property values, homeowners spent freely, often taking on new mortgages to finance a consumption boom. Rising home sales and consumer spending boosted government tax revenues, and in turn the government raised social spending and salaries for government workers. The Irish banks were happy to lend money to finance construction and home purchases.

When the global economic crisis hit in 2008–2009, demand for Ireland's exports slumped. The economy went into a tailspin, the housing bubble burst, and unemployment surged to about 14 percent. Irish banks suddenly found themselves loaded with bad debts and on the verge of collapse. The Irish Government, feeling it had no choice, stepped in, bailing out the banks and guaranteeing their debt. This bailout pushed Ireland's budget deficit up from about 10 percent of GDP to 32 percent, and public debt to around 180 percent of GDP, up from 60 percent. With this level of indebtedness, investors began to worry about the security of Irish



government debt. Irish bond prices dropped and yields soared. By November 2010, the interest rate on 10-year Irish government bonds were 6.85 percent more than the equivalent German government bonds. This dramatically boosted the cost of serving Ireland's ballooning debt and raised the very real possibility that Ireland's government might be unable to meet its debt commitments and do the unthinkable, default on the payment of its debt.

An Irish default would have implications far beyond the country's borders. Three other countries in the euro zone were also having significant financial problems—Greece, Spain, and Portugal. In May 2010 several of the stronger EU nations, led by Germany, had teamed up with the International Monetary Fund (IMF) to put a €110 billion rescue package in place for Greece to forestall the possibility of default there. Now it looked like Ireland might default, which could trigger defaults in Portugal and Spain, and potentially cause a major drop in the value of the euro on foreign exchange markets. This would not only harm the EU, but it would also potentially destabilize the entire global monetary system. Since its creation in 1999, the euro had grown to become one of the world's major currencies. By 2010, about 27 percent of the foreign exchange reserves of governments around the world were held in the form of euros, making it second only to the U.S. dollar in terms of importance as a reserve currency.

To forestall the crisis from spreading, in November 2010 the Irish government agreed to a €90 billion rescue plan from the European Union and the IMF. The loans will allow the Irish government to recapitalize its banking sector and put government finances on a more stable footing. In return, the Irish government agreed to strict austerity measures including increased taxes, sharp cuts in social benefit programs, and a reduction in the national minimum wage. The goal is to reduce the government's budget deficit to 3 percent of GDP by 2015, down from 32 percent in 2010. For now, the move seems to have calmed nervous financial markets and the value of the euro has firmed on the foreign exchange market.[1]

Introduction

What happened in Ireland goes to the heart of the subject matter covered in this chapter. Here we look at the international monetary system, and its role in determining exchange rates. The **international monetary system** refers to the institutional arrangements that govern exchange rates. In Chapter 10 we assumed the foreign exchange market was the primary institution for determining exchange rates, and the impersonal market forces of demand and supply determined the relative value of any two currencies (i.e., their exchange rate). Furthermore, we explained that the demand and supply of currencies is influenced by their respective countries' relative inflation rates and interest rates. When the foreign exchange market determines the relative value of a currency, we say that the country is adhering to a **floating exchange rate** regime. Four of the world's major trading currencies—the U.S. dollar, the European Union's euro, the Japanese yen, and the British pound—are all free to float against each other. Thus, their exchange rates are determined by market forces and fluctuate against each other day to day, if not minute to minute. However, the exchange rates of many currencies are not determined by the free play of market forces; other institutional arrangements are adopted.

Many of the world's developing nations peg their currencies, primarily to the dollar or the euro. A **pegged exchange rate** means the value of the currency is fixed relative to a reference currency, such as the U.S. dollar, and then the exchange rate between that currency and other currencies is determined by the reference currency exchange rate. Similarly, many of the states around the Gulf of Arabia have long pegged their currencies to the dollar.

Other countries, while not adopting a formal pegged rate, try to hold the value of their currency within some range against an important reference currency such as the U.S. dollar, or a "basket" of currencies. This is often referred to as a **dirty float**. It is a float because in theory, the value of the currency is determined by market forces, but it is a *dirty float* (as opposed to a clean float) because the central bank of a country will intervene in the foreign exchange market to try to maintain the value of its currency if it depreciates too rapidly against an important reference currency. This has been the policy adopted by the Chinese since July 2005. The value of the Chinese currency, the yuan, has been linked to a basket of other currencies, including the dollar, yen, and euro, and it is allowed to vary in value against individual currencies, but only within tight limits. As discussed in Chapter 5, some believe the Chinese are deliberately holding down the value of their currency to promote exports.

Still other countries have operated with a **fixed exchange rate**, in which the values of a set of currencies are fixed against each other at some mutually agreed on exchange rate. Before the introduction of the euro in 1999, several member states of the European Union operated with fixed exchange rates within the context of the **European Monetary System (EMS)**. For a quarter of a century after World War II, the world's major industrial nations participated in a fixed exchange rate system. Although this system collapsed in 1973, some still argue that the world should attempt to reestablish it.

This chapter will explain how the international monetary system works and point out its implications for international business. To understand how the system works, we must review its evolution. We will begin with a discussion of the gold standard and its breakup during the 1930s. Then we will discuss the 1944 Bretton Woods conference. This established the basic framework for the post-World War II international monetary system. The Bretton Woods system called for fixed exchange rates against the U.S. dollar. Under this fixed exchange rate system, the value of most currencies in terms of U.S. dollars was fixed for long periods and allowed to change only under a specific set of circumstances. The Bretton Woods conference also created two major international institutions that play a role in the international monetary system—the International Monetary Fund (IMF) and the World Bank. The IMF was given the task of maintaining

order in the international monetary system; the World Bank's role was to promote development.

Today, both these institutions continue to play major roles in the world economy and in the international monetary system. In 1997 and 1998, for example, the IMF helped several Asian countries deal with the dramatic decline in the value of their currencies that occurred during the Asian financial crisis that started in 1997. The IMF was also actively involved in helping Greece and Ireland manage their financial crises in 2010 (see the opening case). In 2011 the IMF had programs in 68 countries, the majority in the developing world, and had some $250 billion in loans to nations.[2] At times of financial crisis, such as what unfolded in 2008–2010, these loan amounts can spike much higher. There has been a vigorous debate about the role of the IMF and to a lesser extent the World Bank and the appropriateness of their policies for many developing nations. Several prominent critics claim that in some cases, IMF policies make things worse, not better (some have argued this may be occurring in Ireland, where very restrictive policies seem likely to depress economic activity, at least for the next few years; see the opening case). The debate over the role of the IMF took on new urgency given the institution's extensive involvement in the economies of developing countries during the late 1990s and 2000s. Accordingly, we shall discuss the issue in some depth.

The Bretton Woods system of fixed exchange rates collapsed in 1973. Since then, the world has operated with a mixed system in which some currencies are allowed to float freely, but many are either managed by government intervention or pegged to another currency. We will explain the reasons for the failure of the Bretton Woods system as well as the nature of the present system. We will also discuss how pegged exchange rate systems work. More than three decades after the breakdown of the Bretton Woods system, the debate continues over what kind of exchange rate regime is best for the world. Some economists advocate a system in which major currencies are allowed to float against each other. Others argue for a return to a fixed exchange rate regime similar to the one established at Bretton Woods. This debate is intense and important, and we will examine the arguments of both sides.

Finally, we will discuss the implications of all this material for international business. We will see how the exchange rate policy adopted by a government can have an important impact on the outlook for business operations in a given country. We will also look at how the policies adopted by the IMF can have an impact on the economic outlook for a country and, accordingly, on the costs and benefits of doing business in that country.

The Gold Standard

LO1

The gold standard had its origin in the use of gold coins as a medium of exchange, unit of account, and store of value—a practice that dates to ancient times. When international trade was limited in volume, payment for goods purchased from another country was typically made in gold or silver. However, as the volume of international trade expanded in the wake of the Industrial Revolution a more convenient means of financing international trade was needed. Shipping large quantities of gold and silver around the world to finance international trade seemed impractical. The solution adopted was to arrange for payment in paper currency and for governments to agree to convert the paper currency into gold on demand at a fixed rate.

MECHANICS OF THE GOLD STANDARD

Pegging currencies to gold and guaranteeing convertibility is known as the **gold standard**. By 1880, most of the world's major trading nations, including Great Britain, Germany, Japan, and the United States, had adopted the gold standard. Given a common gold standard, the value of any currency in units of any other currency (the exchange rate) was easy to determine.

For example, under the gold standard, one U.S. dollar was defined as equivalent to 23.22 grains of "fine" (pure) gold. Thus, one could, in theory, demand that the U.S. government convert that one dollar into 23.22 grains of gold. Since there are 480 grains in an ounce, one ounce of gold cost $20.67 (480/23.22). The amount of a currency needed to purchase one ounce of gold was referred to as the **gold par value**. The British pound was valued at 113 grains of fine gold. In other words, one ounce of gold cost £4.25 (480/113). From the gold par values of pounds and dollars, we can calculate what the exchange rate was for converting pounds into dollars; it was £1 = $4.87 (i.e., $20.67/£4.25).

STRENGTH OF THE GOLD STANDARD

The great strength claimed for the gold standard was that it contained a powerful mechanism for achieving balance-of-trade equilibrium by all countries.[3] A country is said to be in **balance-of-trade equilibrium** when the income its residents earn from exports is equal to the money its residents pay to other countries for imports (the current account of its balance of payments is in balance). Suppose there are only two countries in the world, Japan and the United States. Imagine Japan's trade balance is in surplus because it exports more to the United States than it imports from the United States. Japanese exporters are paid in U.S. dollars, which they exchange for Japanese yen at a Japanese bank. The Japanese bank submits the dollars to the U.S. government and demands payment of gold in return. (This is a simplification of what would occur, but it will make our point.)

Under the gold standard, when Japan has a trade surplus, there will be a net flow of gold from the United States to Japan. These gold flows automatically reduce the U.S. money supply and swell Japan's money supply. As we saw in Chapter 9, there is a close connection between money supply growth and price inflation. An increase in money supply will raise prices in Japan, while a decrease in the U.S. money supply will push U.S. prices downward. The rise in the price of Japanese goods will decrease demand for these goods, while the fall in the price of U.S. goods will increase demand for these goods. Thus, Japan will start to buy more from the United States, and the United States will buy less from Japan, until a balance-of-trade equilibrium is achieved.

This adjustment mechanism seems so simple and attractive that even today, almost 70 years after the final collapse of the gold standard, some people believe the world should return to a gold standard.

THE PERIOD BETWEEN THE WARS: 1918–1939

The gold standard worked reasonably well from the 1870s until the start of World War I in 1914, when it was abandoned. During the war, several governments financed part of their massive military expenditures by printing money. This resulted in inflation, and by the war's end in 1918, price levels were higher everywhere. The United States returned to the gold standard in 1919, Great Britain in 1925, and France in 1928.

Great Britain returned to the gold standard by pegging the pound to gold at the prewar gold parity level of £4.25 per ounce, despite substantial inflation between 1914 and 1925. This priced British goods out of foreign markets, which pushed the country into a deep depression. When foreign holders of pounds lost confidence in Great Britain's commitment to maintaining its currency's value, they began converting their holdings of pounds into gold. The British government saw that it could not satisfy the demand for gold without seriously depleting its gold reserves, so it suspended convertibility in 1931.

The United States followed suit and left the gold standard in 1933 but returned to it in 1934, raising the dollar price of gold from $20.67 per ounce to $35 per ounce. Since more dollars were needed to buy an ounce of gold than before, the implication was that the dollar was worth less. This effectively amounted to a devaluation of the dollar relative to other currencies. Thus, before the devaluation, the pound/dollar exchange rate was £1 = $4.87, but after the devaluation it was £1 = $8.24. By reducing the price of U.S. exports and increasing the price of imports, the government was trying to create

employment in the United States by boosting output (the U.S. government was basically using the exchange rate as an instrument of trade policy—something it now accuses China of doing). However, a number of other countries adopted a similar tactic, and in the cycle of competitive devaluations that soon emerged, no country could win.

The net result was the shattering of any remaining confidence in the system. With countries devaluing their currencies at will, one could no longer be certain how much gold a currency could buy. Instead of holding on to another country's currency, people often tried to change it into gold immediately, lest the country devalue its currency in the intervening period. This put pressure on the gold reserves of various countries, forcing them to suspend gold convertibility. By the start of World War II in 1939, the gold standard was dead.

The Bretton Woods System LO2

In 1944, at the height of World War II, representatives from 44 countries met at Bretton Woods, New Hampshire, to design a new international monetary system. With the collapse of the gold standard and the Great Depression of the 1930s fresh in their minds, these statesmen were determined to build an enduring economic order that would facilitate postwar economic growth. There was consensus that fixed exchange rates were desirable. In addition, the conference participants wanted to avoid the senseless competitive devaluations of the 1930s, and they recognized that the gold standard would not assure this. The major problem with the gold standard as previously constituted was that no multinational institution could stop countries from engaging in competitive devaluations.

The agreement reached at Bretton Woods established two multinational institutions—the International Monetary Fund (IMF) and the World Bank. The task of the IMF would be to maintain order in the international monetary system and that of the World Bank would be to promote general economic development. The Bretton Woods agreement also called for a system of fixed exchange rates that would be policed by the IMF. Under the agreement, all countries were to fix the value of their currency in terms of gold but were not required to exchange their currencies for gold. Only the dollar remained convertible into gold—at a price of $35 per ounce. Each country decided what it wanted its exchange rate to be vis-à-vis the dollar and then calculated the gold par value of the currency based on that selected dollar exchange rate. All participating countries agreed to try to maintain the value of their currencies within 1 percent of the par value by buying or selling currencies (or gold) as needed. For example, if foreign exchange dealers were selling more of a country's currency than demanded, that country's government would intervene in the foreign exchange markets, buying its currency in an attempt to increase demand and maintain its gold par value.

Another aspect of the Bretton Woods agreement was a commitment not to use devaluation as a weapon of competitive trade policy. However, if a currency became too weak to defend, a devaluation of up to 10 percent would be allowed without any formal approval by the IMF. Larger devaluations required IMF approval.

THE ROLE OF THE IMF

The IMF Articles of Agreement were heavily influenced by the worldwide financial collapse, competitive devaluations, trade wars, high unemployment, hyperinflation in Germany and elsewhere, and general economic disintegration that occurred between the two world wars. The aim of the Bretton Woods agreement, of which the IMF was the main custodian, was to try to avoid a repetition of that chaos through a combination of discipline and flexibility.

Discipline

A fixed exchange rate regime imposes discipline in two ways. First, the need to maintain a fixed exchange rate puts a brake on competitive devaluations and brings stability to the world trade environment. Second, a fixed exchange rate regime imposes monetary discipline

on countries, thereby curtailing price inflation. For example, consider what would happen under a fixed exchange rate regime if Great Britain rapidly increased its money supply by printing pounds. As explained in Chapter 10, the increase in money supply would lead to price inflation. Given fixed exchange rates, inflation would make British goods uncompetitive in world markets, while the prices of imports would become more attractive in Great Britain. The result would be a widening trade deficit in Great Britain, with the country importing more than it exports. To correct this trade imbalance under a fixed exchange rate regime, Great Britain would be required to restrict the rate of growth in its money supply to bring price inflation back under control. Thus, fixed exchange rates are seen as a mechanism for controlling inflation and imposing economic discipline on countries.

Flexibility

Although monetary discipline was a central objective of the Bretton Woods agreement, it was recognized that a rigid policy of fixed exchange rates would be too inflexible. It would probably break down just as the gold standard had. In some cases, a country's attempts to reduce its money supply growth and correct a persistent balance-of-payments deficit could force the country into recession and create high unemployment. The architects of the Bretton Woods agreement wanted to avoid high unemployment, so they built limited flexibility into the system. Two major features of the IMF Articles of Agreement fostered this flexibility: IMF lending facilities and adjustable parities.

The IMF stood ready to lend foreign currencies to members to tide them over during short periods of balance-of-payments deficits, when a rapid tightening of monetary or fiscal policy would hurt domestic employment. A pool of gold and currencies contributed by IMF members provided the resources for these lending operations. A persistent balance-of-payments deficit can lead to a depletion of a country's reserves of foreign currency, forcing it to devalue its currency. By providing deficit-laden countries with short-term foreign currency loans, IMF funds would buy time for countries to bring down their inflation rates and reduce their balance-of-payments deficits. The belief was that such loans would reduce pressures for devaluation and allow for a more orderly and less painful adjustment.

Countries were to be allowed to borrow a limited amount from the IMF without adhering to any specific agreements. However, extensive drawings from IMF funds would require a country to agree to increasingly stringent IMF supervision of its macroeconomic policies. Heavy borrowers from the IMF must agree to monetary and fiscal conditions set down by the IMF, which typically included IMF-mandated targets on domestic money supply growth, exchange rate policy, tax policy, government spending, and so on.

The system of adjustable parities allowed for the devaluation of a country's currency by more than 10 percent if the IMF agreed that a country's balance of payments was in "fundamental disequilibrium." The term *fundamental disequilibrium* was not defined in the IMF's Articles of Agreement, but it was intended to apply to countries that had suffered permanent adverse shifts in the demand for their products. Without devaluation, such a country would experience high unemployment and a persistent trade deficit until the domestic price level had fallen far enough to restore a balance-of-payments equilibrium. The belief was that devaluation could help sidestep a painful adjustment process in such circumstances.

THE ROLE OF THE WORLD BANK

The official name for the World Bank is the International Bank for Reconstruction and Development (IBRD). When the Bretton Woods participants established the World Bank, the need to reconstruct the war-torn economies of Europe was foremost in their minds. The bank's initial mission was to help finance the building of Europe's economy by providing low-interest loans. As it turned out, the World Bank was overshadowed in this role by the Marshall Plan, under which the United States lent money directly to European nations to help them rebuild. So the bank turned its attention to development and began lending money to Third World nations. In the 1950s, the bank concentrated on public-sector projects. Power stations, road building, and other transportation

investments were much in favor. During the 1960s, the bank also began to lend heavily in support of agriculture, education, population control, and urban development.

The bank lends money under two schemes. Under the IBRD scheme, money is raised through bond sales in the international capital market. Borrowers pay what the bank calls a market rate of interest—the bank's cost of funds plus a margin for expenses. This "market" rate is lower than commercial banks' market rate. Under the IBRD scheme, the bank offers low-interest loans to risky customers whose credit rating is often poor, such as the governments of underdeveloped nations.

A second scheme is overseen by the International Development Association (IDA), an arm of the bank created in 1960. Resources to fund IDA loans are raised through subscriptions from wealthy members such as the United States, Japan, and Germany. IDA loans go only to the poorest countries. Borrowers have 50 years to repay at an interest rate of 1 percent a year. The world's poorest nations receive grants and interest-free loans.

The Collapse of the Fixed Exchange Rate System

LO[1]

The system of fixed exchange rates established at Bretton Woods worked well until the late 1960s, when it began to show signs of strain. The system finally collapsed in 1973, and since then we have had a managed-float system. To understand why the system collapsed, one must appreciate the special role of the U.S. dollar in the system. As the only currency that could be converted into gold, and as the currency that served as the reference point for all others, the dollar occupied a central place in the system. Any pressure on the dollar to devalue could wreak havoc with the system, and that is what occurred.

Most economists trace the breakup of the fixed exchange rate system to the U.S. macroeconomic policy package of 1965–1968.[4] To finance both the Vietnam conflict and his welfare programs, President Lyndon Johnson backed an increase in U.S. government spending that was not financed by an increase in taxes. Instead, it was financed by an increase in the money supply, which led to a rise in price inflation from less than 4 percent in 1966 to close to 9 percent by 1968. At the same time, the rise in government spending had stimulated the economy. With more money in their pockets, people spent more—particularly on imports—and the U.S. trade balance began to deteriorate.

The increase in inflation and the worsening of the U.S. foreign trade position gave rise to speculation in the foreign exchange market that the dollar would be devalued. Things came to a head in the spring of 1971 when U.S. trade figures showed that for the first time since 1945, the United States was importing more than it was exporting. This set off massive purchases of German deutsche marks in the foreign exchange market by speculators who guessed that the mark would be revalued against the dollar. On a single day, May 4, 1971, the Bundesbank (Germany's central bank) had to buy $1 billion to hold the dollar/deutsche mark exchange rate at its fixed exchange rate given the great demand for deutsche marks. On the morning of May 5, the Bundesbank purchased another $1 billion during the first hour of foreign exchange trading! At that point, the Bundesbank faced the inevitable and allowed its currency to float.

In the weeks following the decision to float the deutsche mark, the foreign exchange market became increasingly convinced that the dollar would have to be devalued. However, devaluation of the dollar was no easy matter. Under the Bretton Woods provisions, any other country could change its exchange rates against all currencies simply by fixing its dollar rate at a new level. But as the key currency in the system, the dollar could be devalued only if all countries agreed to simultaneously revalue against the dollar. Many countries did not want this, because it would make their products more expensive relative to U.S. products.

To force the issue, President Nixon announced in August 1971 that the dollar was no longer convertible into gold. He also announced that a new 10 percent tax on imports would remain in effect until U.S. trading partners agreed to revalue their currencies against the dollar. This brought the trading partners to the bargaining table, and in

December 1971 an agreement was reached to devalue the dollar by about 8 percent against foreign currencies. The import tax was then removed.

The problem was not solved, however. The U.S. balance-of-payments position continued to deteriorate throughout 1973, while the nation's money supply continued to expand at an inflationary rate. Speculation continued to grow that the dollar was still overvalued and that a second devaluation would be necessary. In anticipation, foreign exchange dealers began converting dollars to deutsche marks and other currencies. After a massive wave of speculation in February 1972, which culminated with European central banks spending $3.6 billion on March 1 to try to prevent their currencies from appreciating against the dollar, the foreign exchange market was closed. When the foreign exchange market reopened March 19, the currencies of Japan and most European countries were floating against the dollar, although many developing countries continued to peg their currency to the dollar, and many do to this day. At that time, the switch to a floating system was viewed as a temporary response to unmanageable speculation in the foreign exchange market. But it is now more than 30 years since the Bretton Woods system of fixed exchange rates collapsed, and the temporary solution looks permanent.

The Bretton Woods system had an Achilles' heel: The system could not work if its key currency, the U.S. dollar, was under speculative attack. The Bretton Woods system could work only as long as the U.S. inflation rate remained low and the United States did not run a balance-of-payments deficit. Once these things occurred, the system soon became strained to the breaking point.

LO1 The Floating Exchange Rate Regime

The floating exchange rate regime that followed the collapse of the fixed exchange rate system was formalized in January 1976 when IMF members met in Jamaica and agreed to the rules for the international monetary system that are in place today.

THE JAMAICA AGREEMENT

The Jamaica meeting revised the IMF's Articles of Agreement to reflect the new reality of floating exchange rates. The main elements of the Jamaica agreement include the following:

- Floating rates were declared acceptable. IMF members were permitted to enter the foreign exchange market to even out "unwarranted" speculative fluctuations.
- Gold was abandoned as a reserve asset. The IMF returned its gold reserves to members at the current market price, placing the proceeds in a trust fund to help poor nations. IMF members were permitted to sell their own gold reserves at the market price.
- Total annual IMF quotas—the amount member countries contribute to the IMF—were increased to $41 billion. (Since then they have been increased to $300 billion while the membership of the IMF has been expanded to include 184 countries. In 2009, the IMF was seeking to increase its funding to help with the global financial crisis). Non-oil-exporting, less developed countries were given greater access to IMF funds.

EXCHANGE RATES SINCE 1973

Since March 1973, exchange rates have become much more volatile and less predictable than they were between 1945 and 1973.[5] This volatility has been partly due to a number of unexpected shocks to the world monetary system, including:

- The oil crisis in 1971, when the Organization of Petroleum Exporting Countries (OPEC) quadrupled the price of oil. The harmful effect of this on the U.S. inflation rate and trade position resulted in a further decline in the value of the dollar.

- The loss of confidence in the dollar that followed a sharp rise in the U.S. inflation rate in 1977–1978.
- The oil crisis of 1979, when OPEC once again increased the price of oil dramatically—this time it was doubled.
- The unexpected rise in the dollar between 1980 and 1985, despite a deteriorating balance-of-payments picture.
- The rapid fall of the U.S. dollar against the Japanese yen and German deutsche mark between 1985 and 1987, and against the yen between 1993 and 1995.
- The partial collapse of the European Monetary System in 1992.
- The 1997 Asian currency crisis, when the Asian currencies of several countries, including South Korea, Indonesia, Malaysia, and Thailand, lost between 50 percent and 80 percent of their value against the U.S. dollar in a few months.
- The decline in the value of the U.S. dollar from 2001 to 2009.

Figure 11.1 summarizes how the value of the U.S. dollar has fluctuated against an index of major trading currencies between 1973 and 2010. (The index, which was set equal to 100 in March 1973, is a weighted average of the foreign exchange values of the U.S. dollar against currencies that circulate widely outside the country of issue.) An interesting phenomenon in Figure 11.1 is the rapid rise in the value of the dollar between 1980 and 1985 and its subsequent fall between 1985 and 1988. A similar, though less pronounced, rise and fall in the value of the dollar occurred between 1995 and 2009. We will briefly discuss the rise and fall of the dollar during these periods, since this tells us something about how the international monetary system has operated in recent years.[6]

The rise in the value of the dollar between 1980 and 1985 occurred when the United States was running a large and growing trade deficit, importing substantially more than it exported. Conventional wisdom would suggest that the increased supply of dollars in the foreign exchange market as a result of the trade deficit should lead to a reduction in the value of the dollar, but as shown in Figure 11.1 it increased in value. Why?

A number of favorable factors overcame the unfavorable effect of a trade deficit. Strong economic growth in the United States attracted heavy inflows of capital from foreign investors seeking high returns on capital assets. High real interest rates attracted foreign investors seeking high returns on financial assets. At the same time, political turmoil in other parts of the world, along with relatively slow economic growth in the developed countries of Europe, helped create the view that the United States was a good place to invest. These inflows of capital increased the demand for dollars in the foreign

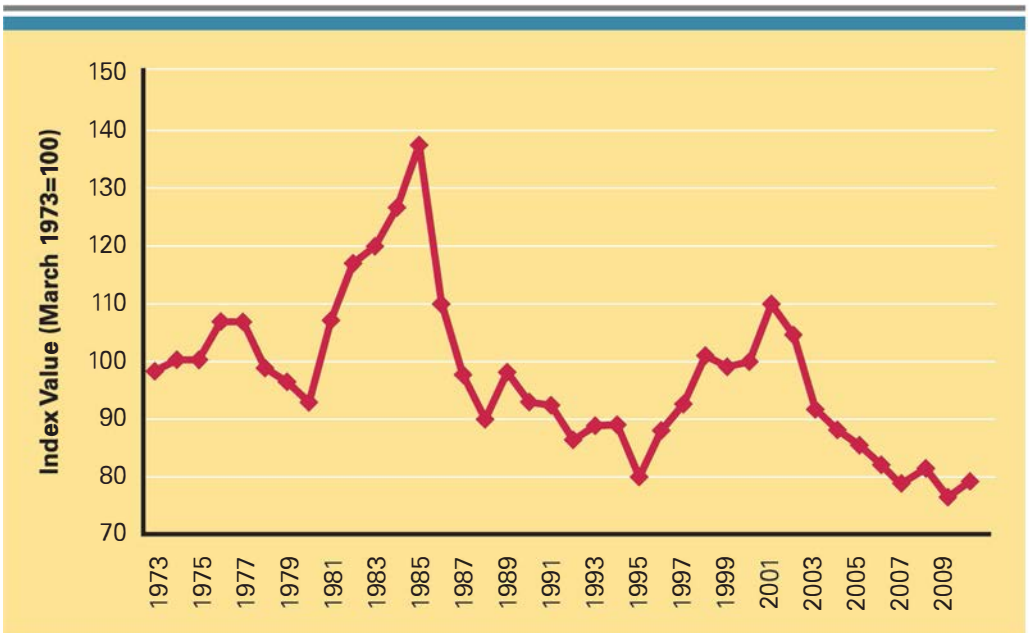

FIGURE 11.1

Major Currencies Dollar Index, 1973–2010

Source: Constructed by the author from Federal Reserve Board statistics at www.federalreserve.gov/releases/H10/summary/.

exchange market, which pushed the value of the dollar upward against other currencies.

The fall in the value of the dollar between 1985 and 1988 was caused by a combination of government intervention and market forces. The rise in the dollar, which priced U.S. goods out of foreign markets and made imports relatively cheap, had contributed to a dismal trade picture. In 1985, the United States posted a then record-high trade deficit of more than $160 billion. This led to growth in demands for protectionism in the United States. In September 1985, the finance ministers and central bank governors of the so-called Group of Five major industrial countries (Great Britain, France, Japan, Germany, and the United States) met at the Plaza Hotel in New York and reached what was later referred to as the Plaza Accord. They announced that it would be desirable for most major currencies to appreciate vis-à-vis the U.S. dollar and pledged to intervene in the foreign exchange markets, selling dollars, to encourage this objective. The dollar had already begun to weaken in the summer of 1985, and this announcement further accelerated the decline.

The dollar continued to decline until 1987. The governments of the Group of Five began to worry that the dollar might decline too far, so the finance ministers of the Group of Five met in Paris in February 1987 and reached a new agreement known as the Louvre Accord. They agreed that exchange rates had been realigned sufficiently and pledged to support the stability of exchange rates around their current levels by intervening in the foreign exchange markets when necessary to buy and sell currency. Although the dollar continued to decline for a few months after the Louvre Accord, the rate of decline slowed, and by early 1988 the decline had ended.

Except for a brief speculative flurry around the time of the Persian Gulf War in 1991, the dollar was relatively stable for the first half of the 1990s. However, in the late 1990s the dollar again began to appreciate against most major currencies, including the euro after its introduction, even though the United States was still running a significant balance-of-payments deficit. Once again, the driving force for the appreciation in the value of the dollar was that foreigners continued to invest in U.S. financial assets, primarily stocks and bonds, and the inflow of money drove up the value of the dollar on foreign exchange markets. The inward investment was due to a belief that U.S. financial assets offered a favorable rate of return.

By 2002, however, foreigners had started to lose their appetite for U.S. stocks and bonds, and the inflow of money into the United States slowed. Instead of reinvesting dollars earned from exports to the United States in U.S. financial assets, they exchanged those dollars for other currencies, particularly euros, to invest them in non-dollar-denominated assets. One reason for this was the continued growth in the U.S. trade deficit, which hit a record $767 billion in 2005 (by 2010 it had fallen to $498 billion). Although the U.S. trade deficits had been hitting records for decades, this deficit was the largest ever when measured as a percentage of the country's GDP (7 percent of GDP in 2005).

The record deficit meant that ever more dollars were flowing out of the United States into foreign hands, and those foreigners were less inclined to reinvest those dollars in the United States at a rate required to keep the dollar stable. This growing reluctance of foreigners to invest in the United States was in turn due to several factors. First, there was a slowdown in U.S. economic activity during 2001–2002, and a somewhat slow recovery thereafter, which made U.S. assets less attractive. Second, the U.S. government's budget deficit expanded rapidly after 2001, hitting a record $318 billion in 2005 before falling back to $158 billion in 2007, and then surging again to $1.4 trillion in 2009 due to government stimulus plans and bailouts in the midst of a deep financial crisis. This led to fears that ultimately the budget deficit would be financed by an expansionary monetary policy that could lead to higher price inflation. Since inflation would reduce the value of the dollar, foreigners decided to hedge against this risk by holding fewer dollar assets in their investment portfolios. Third, from 2003 onward U.S. government officials began to "talk down" the value of the dollar, in part because the administration believed that a cheaper dollar would increase exports and reduce imports, thereby improving the U.S. balance of trade position.[7] Foreigners saw this as a signal that the U.S. government would not intervene in the foreign exchange markets to prop up the value of the dollar, which



COUNTRY FOCUS

The U.S. Dollar, Oil Prices, and Recycling Petrodollars

Between 2004 and 2008 global oil prices surged. They peaked at more than $170 a barrel in 2008, up from about $20 in 2001, before falling sharply back to the mid-$30 range by early 2009. Since then they have increased again, hitting $94 a barrel in early 2011. The rise in oil prices was due to a combination of greater than expected demand for oil, particularly from rapidly developing giants such as China and India, tight supplies, and perceived geopolitical risks in the Middle East, the world's largest oil-producing region.

The surge in oil prices was a windfall for oil-producing countries. Collectively they earned around $700 billion in oil revenues in 2005, and well over $1 trillion in 2007 and 2008, some 64 percent of which went to members of OPEC. Saudi Arabia, the world's largest oil producer, reaped a major share. Because oil is priced in U.S. dollars, the rise in oil prices has translated into a substantial increase in the dollar holdings of oil producers (the dollars earned from the sale of oil are often referred to as *petrodollars*). In essence, rising oil prices represent a net transfer of dollars from oil consumers in countries such as the United States to oil producers in Russia, Saudi Arabia, and Venezuela. What did they do with those dollars?

One option for producing countries was to spend their petrodollars on public-sector infrastructure, such as health services, education, roads, and telecommunications systems. Among other things, this could boost economic growth in those countries and pull in foreign imports, which would help to counterbalance the trade surpluses enjoyed by oil producers and support global economic growth. Spending did indeed pick up in many oil-producing countries. However, according to the IMF, OPEC members spent only about 40 percent of their windfall profits from higher oil prices in 2002–2007 (an exception was Venezuela, whose leader, Hugo Chavez, has been on a spending spree). The last time oil prices increased sharply in 1979, oil producers significantly ramped up spending on infrastructure, only to find themselves saddled with excessive debt when oil prices collapsed a few years later. This time they were more cautious—an approach that seems wise given the rapid collapse in oil prices during late 2008.

Another option was for oil producers to invest a good chunk of the dollars they earn from oil sales in dollar-denominated assets, such as U.S. bonds, stocks, and real estate. This did happen. OPEC members in particular funneled dollars back into U.S. assets, mostly low-risk government bonds. The implication is that by recycling their petrodollars, oil producers helped to finance the large and growing current account deficit of the United States, enabling it to pay its large oil import bill.

A third possibility for oil producers was to invest in non-dollar-denominated assets, including European and Japanese bonds and stocks. This too happened. Also, some OPEC investors have purchased not just small equity positions, but entire companies. In 2005, for example, Dubai International Capital purchased the Tussauds Group, a British theme-park firm, and DP World of Dubai purchased P&O, Britain's biggest port and ferries group. Despite examples such as these, between 2005 and 2008 at least, the bulk of petrodollars appear to have been recycled into dollar-denominated assets. In part this was because U.S. interest rates increased throughout 2004–2007. However, if the flow of petrodollars should dry up, with oil-rich countries investing in other currencies, such as euro-denominated assets, the dollar could fall sharply.[8]

increased their reluctance to reinvest dollars earned from export sales in U.S. financial assets. As a result of these factors, demand for dollars weakened and the value of the dollar slid on the foreign exchange markets, hitting an index value of 80.19 in December 2004, the lowest value since the index began in 1973. Although the dollar strengthened a little in 2005 and 2006, many commentators believe that it could resume its fall in coming years particularly if large holders of U.S. dollars, such as oil-producing states, decide to diversify their foreign exchange holdings (see the accompanying Country Focus for a discussion of this possibility). Indeed, the dollar's fall renewed in 2007, and by February 2011 the dollar index against major currencies stood at 72.9, down from 102.5 in November 2002.

Interestingly, from mid-2008 through early 2009 the dollar staged a moderate rally against major currencies, despite the fact that the American economy was suffering from

a serious financial crisis. The reason seems to be that despite America's problems, things were even worse in many other countries, and foreign investors saw the dollar as a safe haven and put their money in low-risk U.S. assets, particularly low-yielding U.S. government bonds. This rally faltered in mid-2009 as investors became worried about the level of U.S. indebtedness.

In recent history, the value of the dollar has been determined by both market forces and government intervention. Under a floating exchange rate regime, market forces have produced a volatile dollar exchange rate. Governments have sometimes responded by intervening in the market—buying and selling dollars—in an attempt to limit the market's volatility and to correct what they see as overvaluation (in 1985) or potential undervaluation (in 1987) of the dollar. In addition to direct intervention, the value of the dollar has frequently been influenced by statements from government officials. The dollar may not have declined by as much as it did in 2004, for example, had not U.S. government officials publicly ruled out any action to stop the decline. Paradoxically, a signal not to intervene can affect the market. The frequency of government intervention in the foreign exchange market explains why the current system is sometimes thought of as a **managed-float system** or a dirty-float system.

LO3 Fixed versus Floating Exchange Rates

The breakdown of the Bretton Woods system has not stopped the debate about the relative merits of fixed versus floating exchange rate regimes. Disappointment with the system of floating rates in recent years has led to renewed debate about the merits of fixed exchange rates. This section reviews the arguments for fixed and floating exchange rate regimes.[9] We will discuss the case for floating rates before studying why many commentators are disappointed with the experience under floating exchange rates and yearn for a system of fixed rates.

THE CASE FOR FLOATING EXCHANGE RATES

The case in support of floating exchange rates has two main elements: monetary policy autonomy and automatic trade balance adjustments.

Monetary Policy Autonomy

It is argued that under a fixed system, a country's ability to expand or contract its money supply as it sees fit is limited by the need to maintain exchange rate parity. Monetary expansion can lead to inflation, which puts downward pressure on a fixed exchange rate (as predicted by the PPP theory; see Chapter 9). Similarly, monetary contraction requires high interest rates (to reduce the demand for money). Higher interest rates lead to an inflow of money from abroad, which puts upward pressure on a fixed exchange rate. Thus, to maintain exchange rate parity under a fixed system, countries were limited in their ability to use monetary policy to expand or contract their economies.

Advocates of a floating exchange rate regime argue that removal of the obligation to maintain exchange rate parity would restore monetary control to a government. If a government faced with unemployment wanted to increase its money supply to stimulate domestic demand and reduce unemployment, it could do so unencumbered by the need to maintain its exchange rate. While monetary expansion might lead to inflation, this would lead to a depreciation in the country's currency. If PPP theory is correct, the resulting currency depreciation on the foreign exchange markets should offset the effects of inflation. Although under a floating exchange rate regime, domestic inflation would have an impact on the exchange rate, it should have no impact on businesses' international cost competitiveness due to exchange rate depreciation. The rise in domestic costs should be exactly offset by the fall in the value of the country's currency on the foreign exchange markets. Similarly, a government could use monetary policy to contract the economy without worrying about the need to maintain parity.

Trade Balance Adjustments

Under the Bretton Woods system, if a country developed a permanent deficit in its balance of trade (importing more than it exported) that could not be corrected by domestic policy, this would require the IMF to agree to a currency devaluation. Critics of this system argue that the adjustment mechanism works much more smoothly under a floating exchange rate regime. They argue that if a country is running a trade deficit, the imbalance between the supply and demand of that country's currency in the foreign exchange markets (supply exceeding demand) will lead to depreciation in its exchange rate. In turn, by making its exports cheaper and its imports more expensive, an exchange rate depreciation should correct the trade deficit.

THE CASE FOR FIXED EXCHANGE RATES

The case for fixed exchange rates rests on arguments about monetary discipline, speculation, uncertainty, and the lack of connection between the trade balance and exchange rates.

Monetary Discipline

We have already discussed the nature of monetary discipline inherent in a fixed exchange rate system when we discussed the Bretton Woods system. The need to maintain a fixed exchange rate parity ensures that governments do not expand their money supplies at inflationary rates. While advocates of floating rates argue that each country should be allowed to choose its own inflation rate (the monetary autonomy argument), advocates of fixed rates argue that governments all too often give in to political pressures and expand the monetary supply far too rapidly, causing unacceptably high price inflation. A fixed exchange rate regime would ensure that this does not occur.

Speculation

Critics of a floating exchange rate regime also argue that speculation can cause fluctuations in exchange rates. They point to the dollar's rapid rise and fall during the 1980s, which they claim had nothing to do with comparative inflation rates and the U.S. trade deficit, but everything to do with speculation. They argue that when foreign exchange dealers see a currency depreciating, they tend to sell the currency in the expectation of future depreciation regardless of the currency's longer-term prospects. As more traders jump on the bandwagon, the expectations of depreciation are realized. Such destabilizing speculation tends to accentuate the fluctuations around the exchange rate's long-run value. It can damage a country's economy by distorting export and import prices. Thus, advocates of a fixed exchange rate regime argue that such a system will limit the destabilizing effects of speculation.

Uncertainty

Speculation also adds to the uncertainty surrounding future currency movements that characterizes floating exchange rate regimes. The unpredictability of exchange rate movements in the post-Bretton Woods era has made business planning difficult, and it adds risk to exporting, importing, and foreign investment activities. Given a volatile exchange rate, international businesses do not know how to react to the changes—and often they do not react. Why change plans for exporting, importing, or foreign investment after a 6 percent fall in the dollar this month, when the dollar may rise 6 percent next month? This uncertainty, according to the critics, dampens the growth of international trade and investment. They argue that a fixed exchange rate, by eliminating such uncertainty, promotes the growth of international trade and investment. Advocates of a floating system reply that the forward exchange market insures against the risks associated with exchange rate fluctuations (see Chapter 10), so the adverse impact of uncertainty on the growth of international trade and investment has been overstated.

Trade Balance Adjustments

Those in favor of floating exchange rates argue that floating rates help adjust trade imbalances. Critics question the closeness of the link between the exchange rate and the trade balance. They claim trade deficits are determined by the balance between savings and investment in a country, not by the external value of its currency.[10] They argue that depreciation in a currency will lead to inflation (due to the resulting increase in import prices). This inflation will wipe out any apparent gains in cost competitiveness that arise from currency depreciation. In other words, a depreciating exchange rate will not boost exports and reduce imports, as advocates of floating rates claim; it will simply boost price inflation. In support of this argument, those who favor fixed rates point out that the 40 percent drop in the value of the dollar between 1985 and 1988 did not correct the U.S. trade deficit. In reply, advocates of a floating exchange rate regime argue that between 1985 and 1992, the U.S. trade deficit fell from more than $160 billion to about $70 billion, and they attribute this in part to the decline in the value of the dollar.

WHO IS RIGHT?

Which side is right in the vigorous debate between those who favor a fixed exchange rate and those who favor a floating exchange rate? Economists cannot agree. Business, as a major player on the international trade and investment scene, has a large stake in the resolution of the debate. Would international business be better off under a fixed regime, or are flexible rates better? The evidence is not clear.

However, a fixed exchange rate regime modeled along the lines of the Bretton Woods system probably will not work. Speculation ultimately broke the system, a phenomenon that advocates of fixed rate regimes claim is associated with floating exchange rates! Nevertheless, a different kind of fixed exchange rate system might be more enduring and might foster the stability that would facilitate more rapid growth in international trade and investment. In the next section, we look at potential models for such a system and the problems with such systems.

LO4 Exchange Rate Regimes in Practice

Governments around the world pursue a number of different exchange rate policies. These range from a pure "free float" where the exchange rate is determined by market forces to a pegged system that has some aspects of the pre-1973 Bretton Woods system of fixed exchange rates. Figure 11.2 summarizes the exchange rate policies adopted by member states of the IMF. Some 14 percent of the IMF's members allow their currency to float freely. Another 26 percent intervene in only a limited way (the so-called managed float). A further 22 percent of IMF members now have no separate legal tender of their own. These include the European Union countries that have adopted the euro, and effectively given up their own currencies, along with smaller states mostly in Africa or the Caribbean that have no domestic currency and have adopted a foreign currency as legal tender within their borders, typically the U.S. dollar or the euro. The remaining countries use more inflexible systems, including a fixed peg arrangement (28 percent) under which they peg their currencies to other currencies, such as the U.S. dollar or the euro, or to a basket of currencies. Other countries have adopted a system under which their exchange rate is allowed to fluctuate against other currencies within a target zone (an adjustable peg system). In this section, we will look more closely at the mechanics and implications of exchange rate regimes that rely on a currency peg or target zone.

PEGGED EXCHANGE RATES

Under a pegged exchange rate regime, a country will peg the value of its currency to that of a major currency so that, for example, as the U.S. dollar rises in value, its own currency rises too. Pegged exchange rates are popular among many of the world's smaller nations.

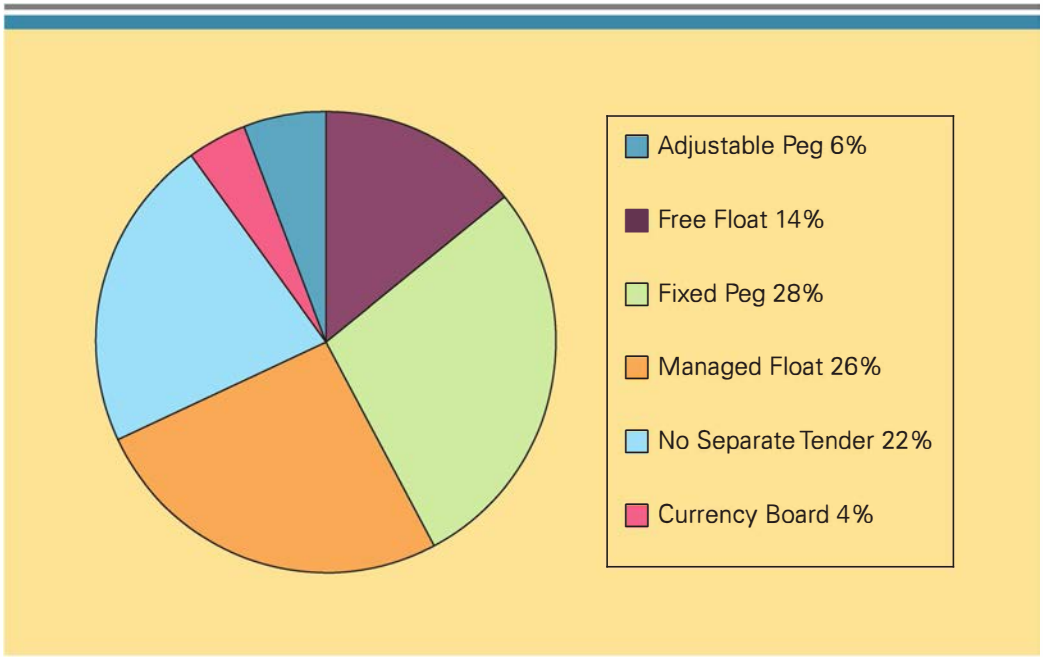

FIGURE 11.2

Exchange Rate Policies of IMF Members

Source: Constructed by the author from International Monetary Fund data.

As with a full fixed exchange rate regime, the great virtue claimed for a pegged exchange rate is that it imposes monetary discipline on a country and leads to low inflation. For example, if Belize pegs the value of the Belizean dollar to that of the U.S. dollar so that US$1 = B$1.97, then the Belizean government must make sure the inflation rate in Belize is similar to that in the United States. If the Belizean inflation rate is greater than the U.S. inflation rate, this will lead to pressure to devalue the Belizean dollar (i.e., to alter the peg). To maintain the peg, the Belizean government would be required to rein in inflation. Of course, for a pegged exchange rate to impose monetary discipline on a country, the country whose currency is chosen for the peg must also pursue sound monetary policy.

Evidence shows that adopting a pegged exchange rate regime moderates inflationary pressures in a country. An IMF study concluded that countries with pegged exchange rates had an average annual inflation rate of 8 percent, compared with 14 percent for intermediate regimes and 16 percent for floating regimes.[11] However, many countries operate with only a nominal peg and in practice are willing to devalue their currency rather than pursue a tight monetary policy. It can be very difficult for a smaller country to maintain a peg against another currency if capital is flowing out of the country and foreign exchange traders are speculating against the currency. Something like this occurred in 1997 when a combination of adverse capital flows and currency speculation forced several Asian countries, including Thailand and Malaysia, to abandon pegs against the U.S. dollar and let their currencies float freely. Malaysia and Thailand would not have been in this position had they dealt with a number of problems that began to arise in their economies during the 1990s, including excessive private-sector debt and expanding current account trade deficits.

CURRENCY BOARDS

Hong Kong's experience during the 1997 Asian currency crisis added a new dimension to the debate over how to manage a pegged exchange rate. During late 1997 when other Asian currencies were collapsing, Hong Kong maintained the value of its currency against the U.S. dollar at about HK$15 = $7.80 despite several concerted speculative attacks. Hong Kong's currency board has been given credit for this success. A country that introduces a **currency board** commits itself to converting its domestic currency on demand into another currency at a fixed exchange rate. To make this commitment credible, the currency board holds reserves of foreign currency equal at the fixed exchange

rate to at least 100 percent of the domestic currency issued. The system used in Hong Kong means its currency must be fully backed by the U.S. dollar at the specified exchange rate. This is still not a true fixed exchange rate regime, because the U.S. dollar, and by extension the Hong Kong dollar, floats against other currencies, but it has some features of a fixed exchange rate regime.

Under this arrangement, the currency board can issue additional domestic notes and coins only when there are foreign exchange reserves to back it. This limits the ability of the government to print money and, thereby, create inflationary pressures. Under a strict currency board system, interest rates adjust automatically. If investors want to switch out of domestic currency into, for example, U.S. dollars, the supply of domestic currency will shrink. This will cause interest rates to rise until it eventually becomes attractive for investors to hold the local currency again. In the case of Hong Kong, the interest rate on three-month deposits climbed as high as 20 percent in late 1997, as investors switched out of Hong Kong dollars and into U.S. dollars. The dollar peg held, however, and interest rates declined again.

Since its establishment in 1983, the Hong Kong currency board has weathered several storms, including the latest. This success persuaded several other countries in the developing world to consider a similar system. Argentina introduced a currency board in 1991 (but abandoned it in 2002) and Bulgaria, Estonia, and Lithuania have all gone down this road in recent years (seven IMF members have currency boards). Despite interest in the arrangement, however, critics are quick to point out that currency boards have their drawbacks.[12] If local inflation rates remain higher than the inflation rate in the country to which the currency is pegged, the currencies of countries with currency boards can become uncompetitive and overvalued (this is what happened in the case of Argentina, which had a currency board). Also, under a currency board system, government lacks the ability to set interest rates. Interest rates in Hong Kong, for example, are effectively set by the U.S. Federal Reserve. In addition, economic collapse in Argentina in 2001 and the subsequent decision to abandon its currency board dampened much of the enthusiasm for this mechanism of managing exchange rates.

LO5 Crisis Management by the IMF

Many observers initially believed that the collapse of the Bretton Woods system in 1973 would diminish the role of the IMF within the international monetary system. The IMF's original function was to provide a pool of money from which members could borrow, short term, to adjust their balance-of-payments position and maintain their exchange rate. Some believed the demand for short-term loans would be considerably diminished under a floating exchange rate regime. A trade deficit would presumably lead to a decline in a country's exchange rate, which would help reduce imports and boost exports. No temporary IMF adjustment loan would be needed. Consistent with this, after 1973, most industrialized countries tended to let the foreign exchange market determine exchange rates in response to demand and supply. No major industrial country has borrowed funds from the IMF since the mid-1970s, when Great Britain and Italy did. Since the early 1970s, the rapid development of global capital markets has allowed developed countries such as Great Britain and the United States to finance their deficits by borrowing private money, as opposed to drawing on IMF funds. Despite these developments, the activities of the IMF have expanded over the past 30 years. By 2010, the IMF had 186 members, 54 of which had some kind of IMF program in place. In 1997, the institution implemented its largest rescue packages until that date, committing more than $110 billion in short-term loans to three troubled Asian countries—South Korea, Indonesia, and Thailand. This was followed by additional IMF rescue packages in Turkey, Russia, Argentina, and Brazil. IMF loans increased again in late 2008 as the global financial crisis took hold (see the opening case). Between 2008 and 2010 the IMF made more than $100 billion in loans to troubled economies such as Latvia, Greece, and Ireland. In April 2009, in response to the growing financial crisis, major IMF members

agreed to triple the institution's resources from $250 billion to $750 billion, thereby giving the IMF the financial leverage to act aggressively in times of global financial crisis.

The IMF's activities have expanded because periodic financial crises have continued to hit many economies in the post-Bretton Woods era. The IMF has repeatedly lent money to nations experiencing financial crises, requesting in return that the governments enact certain macroeconomic policies. Critics of the IMF claim these policies have not always been as beneficial as the IMF might have hoped and in some cases may have made things worse. Following the IMF loans to several Asian economies, these criticisms reached new levels and a vigorous debate was waged as to the appropriate role of the IMF. In this section, we shall discuss some of the main challenges the IMF has had to deal with over the past three decades and review the ongoing debate over the role of the IMF.

FINANCIAL CRISES IN THE POST-BRETTON WOODS ERA

A number of broad types of financial crises have occurred over the past 30 years, many of which have required IMF involvement. A **currency crisis** occurs when a speculative attack on the exchange value of a currency results in a sharp depreciation in the value of the currency or forces authorities to expend large volumes of international currency reserves and sharply increase interest rates to defend the prevailing exchange rate. This is what happened in Brazil in 2002, and the IMF stepped in to help stabilize the value of the Brazilian currency on foreign exchange markets. A **banking crisis** refers to a loss of confidence in the banking system that leads to a run on banks, as individuals and companies withdraw their deposits. A **foreign debt crisis** is a situation in which a country cannot service its foreign debt obligations, whether private-sector or government debt. This is what happened to Greece and Ireland in 2010 (see the opening case).

These crises tend to have common underlying macroeconomic causes: high relative price inflation rates, a widening current account deficit, excessive expansion of domestic borrowing, and asset price inflation (such as sharp increases in stock and property prices).[13] At times, elements of currency, banking, and debt crises may be present simultaneously, as in the 1997 Asian crisis, the 2000–2002 Argentinean crisis, and the 2010 crisis in Ireland.

To assess the frequency of financial crises, the IMF looked at the macroeconomic performance of a group of 53 countries from 1975 to 1997 (22 of these countries were developed nations, and 31 were developing countries).[14] The IMF found there had been 158 currency crises, including 55 episodes in which a country's currency declined by more than 25 percent. There were also 54 banking crises. The IMF's data suggest that developing nations were more than twice as likely to experience currency and banking crises as developed nations. It is not surprising, therefore, that most of the IMF's loan activities since the mid-1970s have been targeted toward developing nations.

Here we look at two crises that have been of particular significance in terms of IMF involvement since the early 1990s—the 1995 Mexican currency crisis and the 1997 Asian financial crisis. These crises were the result of excessive foreign borrowings, a weak or poorly regulated banking system, and high inflation rates. These factors came together to trigger simultaneous debt and currency crises. Checking the resulting crises required IMF involvement.

MEXICAN CURRENCY CRISIS OF 1995

The Mexican peso had been pegged to the dollar since the early 1980s when the International Monetary Fund made it a condition for lending money to the Mexican government to help bail the country out of a 1982 financial crisis. Under the IMF-brokered arrangement, the peso had been allowed to trade within a tolerance band of plus or minus 3 percent against the dollar. The band was also permitted to "crawl" down daily, allowing for an annual peso depreciation of about 4 percent against the dollar. The IMF believed that the need to maintain the exchange rate within a fairly narrow trading band would force the Mexican government to adopt stringent financial policies to limit the growth in the money supply and contain inflation.

Until the early 1990s, it looked as if the IMF policy had worked. However, the strains were beginning to show by 1994. Since the mid-1980s, Mexican producer prices had risen 45 percent more than prices in the United States, and yet there had not been a corresponding adjustment in the exchange rate. By late 1994, Mexico was running a $17 billion trade deficit, which amounted to some 6 percent of the country's gross domestic product, and there had been an uncomfortably rapid expansion in public- and private-sector debt. Despite these strains, Mexican government officials had been stating publicly they would support the peso's dollar peg at around $1 = 3.5 pesos by adopting appropriate monetary policies and by intervening in the currency markets if necessary. Encouraged by such statements, $64 billion of foreign investment money poured into Mexico between 1990 and 1994 as corporations and money managers sought to take advantage of the booming economy.

However, many currency traders concluded the peso would have to be devalued, and they began to dump pesos on the foreign exchange market. The government tried to hold the line by buying pesos and selling dollars, but it lacked the foreign currency reserves required to halt the speculative tide (Mexico's foreign exchange reserves fell from $6 billion at the beginning of 1994 to less than $3.5 billion at the end of the year). In mid-December 1994, the Mexican government abruptly announced a devaluation. Immediately, much of the short-term investment money that had flowed into Mexican stocks and bonds over the previous year reversed its course, as foreign investors bailed out of peso-denominated financial assets. This exacerbated the sale of the peso and contributed to the rapid 40 percent drop in its value.

The IMF stepped in again, this time arm in arm with the U.S. government and the Bank for International Settlements. Together the three institutions pledged close to $50 billion to help Mexico stabilize the peso and to redeem $47 billion of public- and private-sector debt that was set to mature in 1995. Of this amount, $20 billion came from the U.S. government and another $18 billion came from the IMF (which made Mexico the largest recipient of IMF aid up to that point). Without the aid package, Mexico would probably have defaulted on its debt obligations, and the peso would have gone into free fall. As is normal in such cases, the IMF insisted on tight monetary policies and further cuts in public spending, both of which helped push the country into a deep recession. However, the recession was relatively short-lived, and by 1997 the country was once more on a growth path, had pared down its debt, and had paid back the $20 billion borrowed from the U.S. government ahead of schedule.[15]

THE ASIAN CRISIS

The financial crisis that erupted across Southeast Asia during the fall of 1997 emerged as the biggest challenge to date for the IMF. Holding the crisis in check required IMF loans to help the shattered economies of Indonesia, Thailand, and South Korea stabilize their currencies. In addition, although they did not request IMF loans, the economies of Japan, Malaysia, Singapore, and the Philippines were also hurt by the crisis.

The seeds of this crisis were sown during the previous decade when these countries were experiencing unprecedented economic growth. Although there were and remain important differences between the individual countries, a number of elements were common to most. Exports had long been the engine of economic growth in these countries. From 1990 to 1996, the value of exports from Malaysia had grown by 18 percent annually, Thai exports had grown by 16 percent per year, Singapore's by 15 percent, Hong Kong's by 14 percent, and those of South Korea and Indonesia by 12 percent annually.[16]

The nature of these exports had also shifted in recent years from basic materials and products such as textiles to complex and increasingly high-technology products, such as automobiles, semiconductors, and consumer electronics.

The Investment Boom

The wealth created by export-led growth helped fuel an investment boom in commercial and residential property, industrial assets, and infrastructure. The value of commercial

and residential real estate in cities such as Hong Kong and Bangkok soared. This fed a building boom the likes of which had never been seen in Asia. Heavy borrowing from banks financed much of this construction. As for industrial assets, the success of Asian exporters encouraged them to make bolder investments in industrial capacity. This was exemplified most clearly by South Korea's giant diversified conglomerates, or *chaebol*, many of which had ambitions to build a major position in the global automobile and semiconductor industries.

An added factor behind the investment boom in most Southeast Asian economies was the government. In many cases, the governments had embarked on huge infrastructure projects. In Malaysia, for example, a new government administrative center was being constructed in Putrajaya for M$20 billion (U.S. $8 billion at the pre-July 1997 exchange rate), and the government was funding the development of a massive high-technology communications corridor and the huge Bakun dam, which at a cost of M$13.6 billion was to be the most expensive power-generation plant in the country.[17] Throughout the region, governments also encouraged private businesses to invest in certain sectors of the economy in accordance with "national goals" and "industrialization strategy." In South Korea, long a country where the government played a proactive role in private-sector investments, President Kim Young-Sam urged the *chaebol* to invest in new factories as a way of boosting economic growth. South Korea enjoyed an investment-led economic boom in 1994–1995, but at a cost. The *chaebol*, always reliant on heavy borrowings, built up massive debts that were equivalent, on average, to four times their equity.[18]

In Indonesia, President Suharto had long supported investments in a network of an estimated 300 businesses owned by his family and friends in a system known as "crony capitalism." Many of these businesses were granted lucrative monopolies by the president. For example, Suharto announced in 1995 that he had decided to manufacture a national car, built by a company owned by one of his sons, Hutomo Mandala Putra, in association with Kia Motors of South Korea. To support the venture, a consortium of Indonesian banks was "ordered" by the government to offer almost $700 million in start-up loans to the company.[19]

By the mid-1990s, Southeast Asia was in the grips of an unprecedented investment boom, much of it financed with borrowed money. Between 1990 and 1995, gross domestic



The boom in commercial and residential real estate in Asia in the early 1990s was fueled by export-led growth.

investment grew by 16.3 percent annually in Indonesia, 16 percent in Malaysia, 15.3 percent in Thailand, and 7.2 percent in South Korea. By comparison, investment grew by 4.1 percent annually over the same period in the United States and 0.8 percent in all high-income economies.[20] And the rate of investment accelerated in 1996. In Malaysia, for example, spending on investment accounted for a remarkable 43 percent of GDP in 1996.[21]

Excess Capacity

As the volume of investments ballooned during the 1990s, often at the bequest of national governments, the quality of many of these investments declined significantly. The investments often were made on the basis of unrealistic projections about future demand conditions. The result was significant excess capacity. For example, South Korean *chaebol* investments in semiconductor factories surged in 1994 and 1995 when a temporary global shortage of dynamic random access memory chips (DRAMs) led to sharp price increases for this product. However, supply shortages had disappeared by 1996 and excess capacity was beginning to make itself felt, just as the South Koreans started to bring new DRAM factories on stream. The results were predictable; prices for DRAMs plunged, and the earnings of South Korean DRAM manufacturers fell by 90 percent, which meant it was difficult for them to make scheduled payments on the debt they had taken on to build the extra capacity.[22]

In another example, a building boom in Thailand resulted in excess capacity in residential and commercial property. By early 1997, an estimated 365,000 apartment units were unoccupied in Bangkok. With another 100,000 units scheduled to be completed in 1997, years of excess demand in the Thai property market had been replaced by excess supply. By one estimate, Bangkok's building boom had produced enough excess space by 1997 to meet its residential and commercial needs for five years.[23]

The Debt Bomb

By early 1997 what was happening in the South Korean semiconductor industry and the Bangkok property market was being played out elsewhere in the region. Massive investments in industrial assets and property had created excess capacity and plunging prices, while leaving the companies that had made the investments groaning under huge debt burdens that they were now finding it difficult to service.

To make matters worse, much of the borrowing had been in U.S. dollars, as opposed to local currencies. This had originally seemed like a smart move. Throughout the region, local currencies were pegged to the dollar, and interest rates on dollar borrowings were generally lower than rates on borrowings in domestic currency. Thus, it often made economic sense to borrow in dollars if the option was available. However, if the governments could not maintain the dollar peg and their currencies started to depreciate against the dollar, this would increase the size of the debt burden when measured in the local currency. Currency depreciation would raise borrowing costs and could result in companies defaulting on their debt obligations.

Expanding Imports

A final complicating factor was that by the mid-1990s, although exports were still expanding across the region, imports were too. The investments in infrastructure, industrial capacity, and commercial real estate were sucking in foreign goods at unprecedented rates. To build infrastructure, factories, and office buildings, Southeast Asian countries were purchasing capital equipment and materials from America, Europe, and Japan. Many Southeast Asian states saw the current accounts of their balance of payments shift strongly into the red during the mid-1990s. By 1995, Indonesia was running a current account deficit that was equivalent to 3.5 percent of its GDP, Malaysia's was 5.9 percent, and Thailand's was 8.1 percent.[24] With deficits like these, it was increasingly difficult for the governments of these countries to maintain their currencies against the U.S. dollar. If that peg could not be held, the local currency value of dollar-denominated debt would

increase, raising the specter of large-scale default on debt service payments. The scene was now set for a potentially rapid economic meltdown.

The Crisis

The Asian meltdown began in mid-1997 in Thailand when it became clear that several key Thai financial institutions were on the verge of default. These institutions had been borrowing dollars from international banks at low interest rates and lending Thai baht at higher interest rates to local property developers. However, due to speculative overbuilding, these developers could not sell their commercial and residential property, forcing them to default on their debt obligations. In turn, the Thai financial institutions seemed increasingly likely to default on their dollar-denominated debt obligations to international banks. Sensing the beginning of the crisis, foreign investors fled the Thai stock market, selling their positions and converting them into U.S. dollars. The increased demand for dollars and increased supply of Thai baht pushed down the dollar/Thai baht exchange rate, while the stock market plunged.

Seeing these developments, foreign exchange dealers and hedge funds started speculating against the baht, selling it short. For the previous 13 years, the Thai baht had been pegged to the U.S. dollar at an exchange rate of about $1 = Bt25. The Thai government tried to defend the peg, but only succeeded in depleting its foreign exchange reserves. On July 2, 1997, the Thai government abandoned its defense and announced it would allow the baht to float freely against the dollar. The baht started a slide that would bring the exchange rate down to $1 = Bt55 by January 1998. As the baht declined, the Thai debt bomb exploded. The 55 percent decline in the value of the baht against the dollar doubled the amount of baht required to serve the dollar-denominated debt commitments taken on by Thai financial institutions and businesses. This increased the probability of corporate bankruptcies and further pushed down the battered Thai stock market. The Thailand Set stock market index ultimately declined from 787 in January 1997 to a low of 337 in December of that year, on top of a 45 percent decline in 1996.

On July 28, the Thai government called in the International Monetary Fund. With its foreign exchange reserves depleted, Thailand lacked the foreign currency needed to finance its international trade and service debt commitments and desperately needed the capital the IMF could provide. It also needed to restore international confidence in its currency and needed the credibility associated with gaining access to IMF funds. Without IMF loans, the baht likely would increase its free fall against the U.S. dollar and the whole country might go into default. The IMF agreed to provide the Thai government with $17.2 billion in loans, but the conditions were restrictive.[25] The IMF required the Thai government to increase taxes, cut public spending, privatize several state-owned businesses, and raise interest rates—all steps designed to cool Thailand's overheated economy. The IMF also required Thailand to close illiquid financial institutions. In December 1997, the government shut 56 financial institutions, laying off 16,000 people and further deepening the recession that now gripped the country.

Following the devaluation of the Thai baht, wave after wave of speculation hit other Asian currencies. One after another in a period of weeks, the Malaysian ringgit, Indonesian rupiah, and Singaporean dollar were all marked sharply lower. With its foreign exchange reserves down to $28 billion, Malaysia let the ringgit float on July 14, 1997. Before the devaluation, the ringgit was trading at $1 = 2.525 ringgit. Six months later it had declined to $1 = 4.15 ringgit. Singapore followed on July 17, and the Singaporean dollar quickly dropped in value from $1 = S$1.495 before the devaluation to $1 = S$2.68 a few days later. Next up was Indonesia, whose rupiah was allowed to float August 14. For Indonesia, this was the beginning of a precipitous decline in the value of its currency, which was to fall from $1 = 2,400 rupiah in August 1997 to $1 = 10,000 rupiah on January 6, 1998, a loss of 76 percent.

With the exception of Singapore, whose economy is probably the most stable in the region, these devaluations were driven by factors similar to those behind the earlier devaluation of the Thai baht—a combination of excess investment; high borrowings,

much of it in dollar-denominated debt; and a deteriorating balance-of-payments position. Although both Malaysia and Singapore were able to halt the slide in their currencies and stock markets without the help of the IMF, Indonesia was not. Indonesia was struggling with a private-sector, dollar-denominated debt of close to $80 billion. With the rupiah sliding precipitously almost every day, the cost of servicing this debt was exploding, pushing more Indonesian companies into technical default.

On October 31, 1997, the IMF announced it had assembled a $37 billion rescue deal for Indonesia in conjunction with the World Bank and the Asian Development Bank. In return, the Indonesian government agreed to close a number of troubled banks, reduce public spending, remove government subsidies on basic foodstuffs and energy, balance the budget, and unravel the crony capitalism that was so widespread in Indonesia. But the government of President Suharto appeared to backtrack several times on commitments made to the IMF. This precipitated further declines in the Indonesian currency and stock markets. Ultimately, Suharto removed costly government subsidies, only to see the country dissolve into chaos as the populace took to the streets to protest the resulting price increases. This unleashed a chain of events that led to Suharto's removal from power in May 1998.

The final domino to fall was South Korea. During the 1990s, South Korean companies had built up huge debt loads as they invested heavily in new industrial capacity. Now they found they had too much industrial capacity and could not generate the income required to service their debt. South Korean banks and companies had also made the mistake of borrowing in dollars, much of it in the form of short-term loans that would come due within a year. Thus, when the Korean won started to decline in the fall of 1997 in sympathy with the problems elsewhere in Asia, South Korean companies saw their debt obligations balloon. Several large companies were forced to file for bankruptcy. This triggered a decline in the South Korean currency and stock market that was difficult to halt. The South Korean central bank tried to keep the dollar/won exchange rate above $1 = W1,000 but found that this only depleted its foreign exchange reserves. On November 17, the South Korean central bank gave up the defense of the won, which quickly fell to $1 = W1,500.

With its economy on the verge of collapse, the South Korean government on November 21 requested $20 billion in standby loans from the IMF. As the negotiations progressed, it became apparent that South Korea was going to need far more than $20 billion. Among other problems, the country's short-term foreign debt was found to be twice as large as previously thought at close to $100 billion, while the country's foreign exchange reserves were down to less than $6 billion. On December 3, 1997, the IMF and South Korean government reached a deal to lend $55 billion to the country. The agreement with the IMF called for the South Koreans to open their economy and banking system to foreign investors. South Korea also pledged to restrain the *chaebol* by reducing their share of bank financing and requiring them to publish consolidated financial statements and undergo annual independent external audits. On trade liberalization, the IMF said South Korea would comply with its commitments to the World Trade Organization to eliminate trade-related subsidies and restrictive import licensing and would streamline its import certification procedures, all of which should open the South Korean economy to greater foreign competition.[26]

EVALUATING THE IMF'S POLICY PRESCRIPTIONS

By 2010, the IMF was committing loans to some 68 countries that were struggling with economic and/or currency crises. The opening case gave a detailed look at one such crisis in Ireland. Another example of such program is given in the accompanying Country Focus (see page 377), which looks at IMF loans to Turkey. All IMF loan packages come with conditions attached. Until very recently, the IMF has insisted on a combination of tight macroeconomic policies, including cuts in public spending, higher interest rates, and tight monetary policy. It has also often pushed for the deregulation of sectors formerly protected from domestic and foreign competition, privatization of state-owned

assets, and better financial reporting from the banking sector. These policies are designed to cool overheated economies by reining in inflation and reducing government spending and debt. This set of policy prescriptions has come in for tough criticisms from many observers, and the IMF itself has started to change its approach.[27]

Inappropriate Policies

One criticism is that the IMF's traditional policy prescriptions represent a "one-size-fits-all" approach to macroeconomic policy that is inappropriate for many countries. In the case of the Asian crisis, critics argue that the tight macroeconomic policies imposed by the IMF are not well suited to countries that are suffering not from excessive government spending and inflation, but from a private-sector debt crisis with deflationary undertones.[28] In South Korea, for example, the government had been running a budget surplus for years (it was 4 percent of South Korea's GDP in 1994–1996) and inflation was low at about 5 percent. South Korea had the second strongest financial position of any country in the Organization for Economic Cooperation and Development. Despite this, critics say, the IMF insisted on applying the same policies that it applies to countries suffering from high inflation. The IMF required South Korea to maintain an inflation rate of 5 percent. However, given the collapse in the value of its currency and the subsequent rise in price for imports such as oil, critics claimed inflationary pressures would inevitably increase in South Korea. So to hit a 5 percent inflation rate, the South Koreans would be forced to apply an unnecessarily tight monetary policy. Short-term interest rates in South Korea did jump from 12.5 percent to 21 percent immediately after the country signed its initial deal with the IMF. Increasing interest rates made it even more difficult for companies to service their already excessive short-term debt obligations, and critics used this as evidence to argue that the cure prescribed by the IMF may actually increase the probability of widespread corporate defaults, not reduce them.

At the time the IMF rejected this criticism. According to the IMF, the central task was to rebuild confidence in the won. Once this was achieved, the won would recover from its oversold levels, reducing the size of South Korea's dollar-denominated debt burden when expressed in won, making it easier for companies to service their debt. The IMF also argued that by requiring South Korea to remove restrictions on foreign direct investment, foreign capital would flow into the country to take advantage of cheap assets. This, too, would increase demand for the Korean currency and help to improve the dollar/won exchange rate.

South Korea did recover fairly quickly from the crisis, supporting the position of the IMF. While the economy contracted by 7 percent in 1998, by 2000 it had rebounded and grew at a 9 percent rate (measured by growth in GDP). Inflation, which peaked at 8 percent in 1998, fell to 2 percent by 2000, and unemployment fell from 7 percent to 4 percent over the same period. The won hit a low of $1 = W1,812 in early 1998, but by 2000 was back to an exchange rate of around $1 = W1,200, at which it seems to have stabilized.

Moral Hazard

A second criticism of the IMF is that its rescue efforts are exacerbating a problem known to economists as moral hazard. **Moral hazard** arises when people behave recklessly because they know they will be saved if things go wrong. Critics point out that many Japanese and Western banks were far too willing to lend large amounts of capital to overleveraged Asian companies during the boom years of the 1990s. These critics argue that the banks should now be forced to pay the price for their rash lending policies, even if that means some banks must close.[29] Only by taking such drastic action, the argument goes, will banks learn the error of their ways and not engage in rash lending in the future. By providing support to these countries, the IMF is reducing the probability of debt default and in effect bailing out the banks whose loans gave rise to this situation.

This argument ignores two critical points. First, if some Japanese or Western banks with heavy exposure to the troubled Asian economies were forced to write off their loans due to widespread debt default, the impact would have been difficult to contain. The

failure of large Japanese banks, for example, could have triggered a meltdown in the Japanese financial markets. That would almost inevitably lead to a serious decline in stock markets around the world, which was the very risk the IMF was trying to avoid by stepping in with financial support. Second, it is incorrect to imply that some banks have not had to pay the price for rash lending policies. The IMF has insisted on the closure of banks in South Korea, Thailand, and Indonesia. Foreign banks with short-term loans outstanding to South Korean enterprises have been forced by circumstances to reschedule those loans at interest rates that do not compensate for the extension of the loan maturity.

Lack of Accountability

The final criticism of the IMF is that it has become too powerful for an institution that lacks any real mechanism for accountability.[30] The IMF has determined macroeconomic policies in those countries, yet according to critics such as noted economist Jeffrey Sachs, the IMF, with a staff of less than 1,000, lacks the expertise required to do a good job. Evidence of this, according to Sachs, can be found in the fact that the IMF was singing the praises of the Thai and South Korean governments only months before both countries lurched into crisis. Then the IMF put together a draconian program for South Korea without having deep knowledge of the country. Sachs's solution to this problem is to reform the IMF so it makes greater use of outside experts and its operations are open to greater outside scrutiny.

Observations

As with many debates about international economics, it is not clear which side is correct about the appropriateness of IMF policies. There are cases where one can argue that IMF policies have been counterproductive, or only had limited success. For example, one might question the success of the IMF's involvement in Turkey given that the country has had to implement some 18 IMF programs since 1958 (see the accompanying Country Focus)! But the IMF can also point to some notable accomplishments, including its success in containing the Asian crisis, which could have rocked the global international monetary system to its core, and its actions in 2008–2010 to contain the global financial crisis, quickly stepping in to rescue Iceland, Ireland, Greece, and Latvia. Similarly, many observers give the IMF credit for its deft handling of politically difficult situations, such as the Mexican peso crisis, and for successfully promoting a free market philosophy.

Several years after the IMF's intervention, the economies of Asia and Mexico recovered. Certainly they all averted the kind of catastrophic implosion that might have occurred had the IMF not stepped in, and although some countries still faced considerable problems, it is not clear that the IMF should take much blame for this. The IMF cannot force countries to adopt the policies required to correct economic mismanagement. While a government may commit to taking corrective action in return for an IMF loan, internal political problems may make it difficult for a government to act on that commitment. In such cases, the IMF is caught between a rock and a hard place, for if it decided to withhold money, it might trigger financial collapse and the kind of contagion that it seeks to avoid.

Finally, it is notable that in recent years the IMF has started to change its policies. In response to the global financial crisis of 2008–2009, the IMF began to urge countries to adopt policies that included fiscal stimulus and monetary easing—the direct opposite of what the fund traditionally advocated. Some economists in the fund are also now arguing that higher inflation rates might be a good thing, if the consequence is greater growth in aggregate demand, which would help to pull nations out of recessionary conditions. The IMF, in other words, is starting to display the very flexibility in policy responses that its critics claim it lacks. While the traditional policy of tight controls on fiscal policy and tight monetary policy targets might be appropriate for countries suffering from high inflation rates, the Asian economic crisis and the 2008–2009 global financial crisis were caused not by high inflation rates, but by excessive debt, and the IMF's "new approach" seems tailored to deal with this.[31]

Turkey and the IMF

In May 2001, the International Monetary Fund (IMF) agreed to lend $8 billion to Turkey to help the country stabilize its economy and halt a sharp slide in the value of its currency. This was the third time in two years that the international lending institution had put together a loan program for Turkey, and it was the 18th program since Turkey became a member of the IMF in 1958.

Many of Turkey's problems stemmed from a large and inefficient state sector and heavy subsidies to various private sectors of the economy such as agriculture. Although the Turkish government started to privatize state-owned companies in the late 1980s, the programs proceeded at a glacial pace, hamstrung by political opposition within Turkey. Instead of selling state-owned assets to private investors, successive governments increased support to unprofitable state-owned industries and raised the wage rates of state employees. Nor did the government cut subsidies to politically powerful private sectors of the economy, such as agriculture. To support state industries and finance subsidies, Turkey issued significant amounts of government debt. To limit the amount of debt, the government expanded the money supply to finance spending. The result was rampant inflation and high interest rates. During the 1990s, inflation averaged over 80 percent a year while real interest rates rose to more than 50 percent on a number of occasions. Despite this, the Turkish economy continued to grow at a healthy pace of 6 percent annually in real terms, a remarkable achievement given the high inflation rates and interest rates.

By the late 1990s the "Turkish miracle" of sustained growth in the face of high inflation and interest rates was running out of steam. Government debt had risen to 60 percent of gross domestic product, government borrowing was leaving little capital for private enterprises, and the cost of financing government debt was spiraling out of control. Rampant inflation was putting pressure on the Turkish currency, the lira, which at the time was pegged in value to a basket of other currencies. Realizing that it needed to reform its economy, the Turkish government sat down with the IMF in late 1999 to work out a recovery program, adopted in January 2000.

As with most IMF programs, the focus was on bringing down the inflation rate, stabilizing the value of the Turkish currency, and restructuring the economy to reduce government debt. The Turkish government committed itself to reducing government debt by taking a number of steps. These included an accelerated privatization program, using the proceeds to pay down debt; the reduction of agricultural subsidies; reform to make it more difficult for people to qualify for public pension programs; and tax increases. The government also agreed to rein in the growth in the money supply to better control inflation. To limit the possibility of speculative attacks on the Turkish currency in the foreign exchange markets, the Turkish government and IMF announced that Turkey would peg the value of the lira against a basket of currencies and devalue the lira by a predetermined amount each month throughout 2000, bringing the total devaluation for the year to 25 percent. To ease the pain, the IMF agreed to provide the Turkish government with $5 billion in loans that could be used to support the value of the lira.

Initially the program seemed to be working. Inflation fell to 35 percent in 2000, while the economy grew by 6 percent. By the end of 2000, however, the program was in trouble. Burdened with nonperforming loans, a number of Turkish banks faced default and had been taken into public ownership by the government. When a criminal fraud investigation uncovered evidence that several of these banks had been pressured by politicians into providing loans at below-market interest rates, foreign investors, worried that more banks might be involved, started to pull their money out of Turkey. This sent the Turkish stock market into a tailspin and put enormous pressure on the Turkish lira. The government raised Turkish overnight interbank lending rates to as high as 1,950 percent to try to stem the outflow of capital, but it was clear that Turkey alone could not halt the flow.

The IMF stepped once more into the breach, December 6, 2000, announcing a quickly arranged $7.5 billion loan program for the country. In return for the loan, the IMF required the Turkish government to close 10 insolvent banks, speed up its privatization plans (which had once more stalled), and cap any pay increases for government workers. The IMF also reportedly urged the Turkish government to let its currency float freely in the foreign exchange markets, but the government refused, arguing that the result would be a rapid devaluation in the lira, which would raise import prices and fuel price inflation. The government insisted that reducing inflation should be its first priority.

This plan started to come apart in February 2001. A surge in inflation and a rapid slowdown in economic

growth once more spooked foreign investors. Into this explosive mix waded Turkey's prime minister and president, who engaged in a highly public argument about economic policy and political corruption. This triggered a rapid outflow of capital. The government raised the overnight interbank lending rate to 7,500 percent to try to persuade foreigners to leave their money in the country, but to no avail. Realizing that it would be unable to keep the lira within its planned monthly devaluation range without raising interest rates to absurd levels or seriously depleting the country's foreign exchange reserves, on February 23, 2001, the Turkish government decided to let the lira float freely. The lira immediately dropped 50 percent in value against the U.S. dollar, but ended the day down some 28 percent.

Over the next two months, the Turkish economy continued to weaken as a global economic slowdown affected the nation. Inflation stayed high, and progress at reforming the country's economy remained bogged down by political considerations. By early April, the lira had fallen 40 percent against the dollar since February 23, and the country was teetering on the brink of an economic meltdown. For the third time in 18 months, the IMF stepped in, arranging for another $8 billion in loans. Once more, the IMF insisted that the Turkish government accelerate privatization, close insolvent banks, deregulate its market, and cut government spending. Critics of the IMF, however, claimed this "austerity program" would only slow the Turkish economy and make matters worse, not better. These critics advocated a mix of sound monetary policy and tax cuts to boost Turkey's economic growth.

By 2007 significant progress had been made. Initially the Turkish government failed to fully comply with IMF mandates on economic policy, causing the institution to hold back a scheduled $1.6 billion in IMF loans until the government passed an "austerity budget," which it did reluctantly in March 2003 after months of public handwringing. Since then, things have improved. Inflation fell from a peak of 65 percent in December 2000 to about 8.2 percent for 2005 and 9 percent for 2007. Economic growth increased to a robust 9 percent in 2004, followed by 5.9 percent in 2005, 5.2 percent in 2006, and 4 percent in 2007. The pace of the privatization program has increased. The government also generated budget surpluses in 2003–2006.[32]

IMPLICATIONS FOR MANAGERS

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The implications for international businesses of the material discussed in this chapter fall into three main areas: currency management, business strategy, and corporate–government relations.

CURRENCY MANAGEMENT

An obvious implication with regard to currency management is that companies must recognize that the foreign exchange market does not work quite as depicted in Chapter 10. The current system is a mixed system in which a combination of government intervention and speculative activity can drive the foreign exchange market. Companies engaged in significant foreign exchange activities need to be aware of this and to adjust their foreign exchange transactions accordingly. For example, the currency management unit of Caterpillar claims it made millions of dollars in the hours following the announcement of the Plaza Accord by selling dollars and buying currencies that it expected to appreciate on the foreign exchange market following government intervention.

Under the present system, speculative buying and selling of currencies can create very volatile movements in exchange rates (as exhibited by the rise and fall of the dollar during the 1980s and the Asian currency crisis of the late 1990s). Contrary to the predictions of the purchasing power parity theory (see Chapter 10), exchange rate movements during the 1980s and 1990s often did not seem to be strongly influenced by relative inflation rates. Insofar as volatile exchange rates increase foreign exchange risk, this is not good news for business. On the other hand, as we saw in Chapter 10, the foreign

exchange market has developed a number of instruments, such as the forward market and swaps, that can help to insure against foreign exchange risk. Not surprisingly, use of these instruments has increased markedly since the breakdown of the Bretton Woods system in 1973.

BUSINESS STRATEGY

The volatility of the present global exchange rate regime presents a conundrum for international businesses. Exchange rate movements are difficult to predict, and yet their movement can have a major impact on a business's competitive position. For a detailed example, see the accompanying Management Focus on Airbus. Faced with uncertainty about the future value of currencies, firms can utilize the forward exchange market, which Airbus has done. However, the forward exchange market is far from perfect as a predictor of future exchange rates (see Chapter 10). It is also difficult if not impossible to get adequate insurance coverage for exchange rate changes that might occur several years in the future. The forward market tends to offer coverage for exchange rate changes a few months—not years—ahead. Given this, it makes sense to pursue strategies that will increase the company's strategic flexibility in the face of unpredictable exchange rate movements—that is, to pursue strategies that reduce the economic exposure of the firm (which we first discussed in Chapter 10).

Maintaining strategic flexibility can take the form of dispersing production to different locations around the globe as a real hedge against currency fluctuations (this seems to be what Airbus is now considering). Consider the case of Daimler-Benz, Germany's export-oriented automobile and aerospace company. In June 1995, the company stunned the German business community when it announced it expected to post a severe loss in 1995 of about $720 million. The cause was Germany's strong currency, which had appreciated by 4 percent against a basket of major currencies since the beginning of 1995 and had risen by more than 30 percent against the U.S. dollar since late 1994. By mid-1995, the exchange rate against the dollar stood at $1 = DM1.38. Daimler's management believed it could not make money with an exchange rate under $1 = DM1.60. Daimler's senior managers concluded the appreciation of the mark against the dollar was probably permanent, so they decided to move substantial production outside of Germany and increase purchasing of foreign components. The idea was to reduce the vulnerability of the company to future exchange rate movements. Even before the company's acquisition of Chrysler Corporation in 1998, the Mercedes-Benz division planned to produce 10 percent of its cars outside of Germany by 2000, mostly in the United States.[33] Similarly, the move by Japanese automobile companies to expand their productive capacity in the United States and Europe can be seen in the context of the increase in the value of the yen between 1985 and 1995, which raised the price of Japanese exports. For the Japanese companies, building production capacity overseas is a hedge against continued appreciation of the yen (as well as against trade barriers).

Another way of building strategic flexibility and reducing economic exposure involves contracting out manufacturing. This allows a company to shift suppliers from country to country in response to changes in relative costs brought about by exchange rate movements. However, this kind of strategy may work only for low-value-added manufacturing (e.g., textiles), in which the individual manufacturers have few if any firm-specific skills that contribute to the value of the product. It may be less appropriate for high-value-added manufacturing, in which firm-specific technology and skills add significant value to the product (e.g., the heavy equipment industry) and in which switching costs are correspondingly high. For high-value-added manufacturing, switching suppliers will lead to a reduction in the value that is added, which may offset any cost gains arising from exchange rate fluctuations.

The roles of the IMF and the World Bank in the present international monetary system also have implications for business strategy. Increasingly, the IMF has been acting as the



MANAGEMENT FOCUS

Airbus and the Euro

Airbus had reason to celebrate in 2003; for the first time in the company's history it delivered more commercial jet aircraft than longtime rival Boeing. Airbus delivered 305 planes in 2003, compared to Boeing's 281. The celebration, however, was muted, for the strength of the euro against the U.S. dollar was casting a cloud over the company's future. Airbus, which is based in Toulouse, France, prices planes in dollars, just as Boeing has always done. But more than half of Airbus's costs are in euros. So as the dollar drops in value against the euro, and it dropped by over 50 percent between 2002 and the end of 2009, Airbus's costs rise in proportion to its revenue, squeezing profits in the process.

In the short run, the fall in the value of the dollar against the euro did not hurt Airbus. The company fully hedged its dollar exposure in 2005 and was mostly hedged for 2006. However, anticipating that the dollar would stay weak against the euro, Airbus started to take other steps to reduce its economic exposure to a strong European currency. Recognizing that raising prices is not an option given the strong competition from Boeing, Airbus decided to focus on reducing its costs. As a step toward doing this, Airbus is giving U.S. suppliers a greater share of work on new aircraft models, such as the A380 super-jumbo and the A350. It is also shifting supply work on some of its older models from European to American-based suppliers. This will increase the proportion of its costs that are in dollars, making profits less vulnerable to a rise in the value of the euro and reducing the costs of building an aircraft when they are converted back into euros.

In addition, Airbus is pushing its European-based suppliers to start pricing in U.S. dollars. Because the costs of many suppliers are in euros, the suppliers are finding that to comply with Airbus's wishes, they too have to move more work to the United States, or to countries whose currency is pegged to the U.S. dollar. Thus, one large French-based supplier, Zodiac, has announced that it was considering acquisitions in the United States. Not only is Airbus pushing suppliers to price components for commercial jet aircraft in dollars, but the company is also requiring suppliers to its A400M program, a military aircraft that will be sold to European governments and priced in euros, to price components in U.S. dollars. Beyond these steps, the CEO of EADS, Airbus's parent company, has publicly stated it might be prepared to assemble aircraft in the United States if that helps to win important U.S. contracts.[34]

macroeconomic police of the world economy, insisting that countries seeking significant borrowings adopt IMF-mandated macroeconomic policies. These policies typically include anti-inflationary monetary policies and reductions in government spending. In the short run, such policies usually result in a sharp contraction of demand. International businesses selling or producing in such countries need to be aware of this and plan accordingly. In the long run, the kind of policies imposed by the IMF can promote economic growth and an expansion of demand, which create opportunities for international business.

CORPORATE–GOVERNMENT RELATIONS

As major players in the international trade and investment environment, businesses can influence government policy toward the international monetary system. For example, intense government lobbying by U.S. exporters helped convince the U.S. government that intervention in the foreign exchange market was necessary. With this in mind, business can and should use its influence to promote an international monetary system that facilitates the growth of international trade and investment. Whether a fixed or floating regime is optimal is a subject for debate. However, exchange rate volatility such as the world experienced during the 1980s and 1990s creates an environment less conducive to international trade and investment than one with more stable exchange rates. Therefore, it would seem to be in the interests of international business to promote an international monetary system that minimizes volatile exchange rate movements, particularly when those movements are unrelated to long-run economic fundamentals.

CHAPTER SUMMARY

This chapter explained the workings of the international monetary system and pointed out its implications for international business. The chapter made the following points:

1. The gold standard is a monetary standard that pegs currencies to gold and guarantees convertibility to gold. It was thought that the gold standard contained an automatic mechanism that contributed to the simultaneous achievement of a balance-of-payments equilibrium by all countries. The gold standard broke down during the 1930s as countries engaged in competitive devaluations.
2. The Bretton Woods system of fixed exchange rates was established in 1944. The U.S. dollar was the central currency of this system; the value of every other currency was pegged to its value. Significant exchange rate devaluations were allowed only with the permission of the IMF. The role of the IMF was to maintain order in the international monetary system (*i*) to avoid a repetition of the competitive devaluations of the 1930s and (*ii*) to control price inflation by imposing monetary discipline on countries.
3. The fixed exchange rate system collapsed in 1973, primarily due to speculative pressure on the dollar following a rise in U.S. inflation and a growing U.S. balance-of-trade deficit.
4. Since 1973 the world has operated with a floating exchange rate regime, and exchange rates have become more volatile and far less predictable. Volatile exchange rate movements have helped reopen the debate over the merits of fixed and floating systems.
5. The case for a floating exchange rate regime claims (*i*) such a system gives countries autonomy regarding their monetary policy and (*ii*) floating exchange rates facilitate smooth adjustment of trade imbalances.
6. The case for a fixed exchange rate regime claims (*i*) the need to maintain a fixed exchange rate imposes monetary discipline on a country, (*ii*) floating exchange rate regimes are vulnerable to speculative pressure, (*iii*) the uncertainty that accompanies floating exchange rates dampens the growth of international trade and investment, and (*iv*) far from correcting trade imbalances, depreciating a currency on the foreign exchange market tends to cause price inflation.
7. In today's international monetary system, some countries have adopted floating exchange rates, some have pegged their currency to another currency such as the U.S. dollar, and some have pegged their currency to a basket of other currencies, allowing their currency to fluctuate within a zone around the basket.
8. In the post-Bretton Woods era, the IMF has continued to play an important role in helping countries navigate their way through financial crises by lending significant capital to embattled governments and by requiring them to adopt certain macroeconomic policies.
9. An important debate is occurring over the appropriateness of IMF-mandated macroeconomic policies. Critics charge that the IMF often imposes inappropriate conditions on developing nations that are the recipients of its loans.
10. The present managed-float system of exchange rate determination has increased the importance of currency management in international businesses.
11. The volatility of exchange rates under the present managed-float system creates both opportunities and threats. One way of responding to this volatility is for companies to build strategic flexibility and limit their economic exposure by dispersing production to different locations around the globe by contracting out manufacturing (in the case of low-value-added manufacturing) and other means.

Critical Thinking and Discussion Questions

1. Why did the gold standard collapse? Is there a case for returning to some type of gold standard? What is it?
2. What opportunities might current IMF lending policies to developing nations create for international businesses? What threats might they create?
3. Do you think the standard IMF policy prescriptions of tight monetary policy and reduced government spending are always appropriate for

developing nations experiencing a currency crisis? How might the IMF change its approach? What would the implications be for international businesses?

4. Debate the relative merits of fixed and floating exchange rate regimes. From the perspective of an international business, what are the most important criteria in a choice between the systems? Which system is the more desirable for an international business?
5. Imagine that Canada, the United States, and Mexico decide to adopt a fixed exchange rate system. What would be the likely consequences of such a system for (*a*) international businesses and (*b*) the flow of trade and investment among the three countries?
6. Reread the Country Focus on the U.S. dollar, oil prices, and recycling petrodollars, then answer the following questions:
   a. What will happen to the value of the U.S. dollar if oil producers decide to invest most of their earnings from oil sales in domestic infrastructure projects?
   b. What factors determine the relative attractiveness of dollar-, euro-, and yen-denominated assets to oil producers flush with petrodollars? What might lead them to direct more funds toward non-dollar-denominated assets?
   c. What will happen to the value of the U.S. dollar if OPEC members decide to invest more of their petrodollars toward non-dollar assets, such as euro-denominated stocks and bonds?
   d. In addition to oil producers, China is also accumulating a large stock of dollars, currently estimated to total $1.4 trillion. What would happen to the value of the dollar if China and oil-producing nations all shifted out of dollar-denominated assets at the same time? What would be the consequence for the U.S. economy?

Research Task globalEDGE globaledge.msu.edu

The International Monetary System

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The quality of life in specific markets sometimes is impacted by the country's financial and fiscal policies. As such, the *Global Financial Stability Report* is a semi-annual report published by the International Capital Markets division of the International Monetary Fund (IMF). The report provides a regular assessment of global financial markets. As such, locate and download the latest report to give an overview of the most important issues under discussion. How do these issues compare with emerging financial issues identified in the report?

Exercise 2

An important element to understanding the international monetary system is keeping updated on current growth trends worldwide. A German colleague told you yesterday that *Deutsche Bank Research*'s research on emerging markets is an effective way to stay informed on important topics in international finance. Find an emerging market research report for analysis. On which emerging market region did you choose to focus? What are the key takeaways from your chosen report?

CLOSING CASE

Economic Turmoil in Latvia

Latvia, a country of 2.5 million people, is one of the three Baltic states that gained independence after the collapse of the Soviet Union. For most of the 2000s, the economic story in Latvia has been one of rapid economic growth powered by a vibrant private sector. The country joined the European Union in 2004 and pegged its currency, the lat, to the value of the euro. The eventual goal for Latvia was to adopt the euro. To maintain parity against the euro, Latvia used a variation of a system known as a currency board, where local

currency in circulation is backed, unit for unit, by reserves of foreign currency, which in Latvia's case was primarily the euro.

From 2006 onward repeated warnings indicated the Latvian economy might be overheating. Increasingly, an economic boom was being sustained by inflows of foreign money into Latvian banks, particularly from Russia. For their part, the banks were using these funds to finance aggressive lending, including leading to an increasingly frothy property market, with prices being bid up by borrowers who could get access to cheap credit. Critics urged the government to rein in the lending by raising interest rates, but to no avail. What the government failed to do, the market ultimately did anyway.

The boom started to unravel in 2008 as a global economic crisis that began with overvaluation in the U.S. property market rolled around the world. For Latvia, the trouble began when the nation's largest private bank, Parex, revealed it was in financial distress. Hurt by rising defaults on the risky loans it had made, Parex sought government help. The government stepped in, initially injecting 200 million lats (about $390 million) into the bank. This did not solve Parex's problems. With depositors rapidly withdrawing money, the government was forced to nationalize the institution. Far from halting the crisis, this seemed to deepen it as individuals and institutions started to pull their money out of the lat, changing it into euros and U.S. dollars. Currency speculators also joined the fray, betting that the government would have to devalue the lat and selling lats short. This put enormous pressure on the Latvian currency, forcing the country's central banks to enter the foreign exchange markets, buying lats in an attempt to maintain the currency peg against the euro. In less than two months, the bank went through more than a fifth of its total foreign exchange reserves, but the money continued to flow out of the country.

One solution to the crisis would have been to devalue the lat against the euro. However, this would have created additional problems. Many Latvians had borrowed in euros. If the lat was depreciated against the euro, the cost of servicing their loans in local currency would have jumped by an amount equal to the depreciation, causing immediate economic hardship for local borrowers.

In December 2008, the Latvian government approached both the European Union and the International Monetary Fund, asking for help. The IMF took the lead in putting together an international rescue package, which totaled some 7.5 billion euros in loans from the IMF, the European Union, neighboring Sweden and Finland, and the World Bank. These funds were to be used to protect the value of the lat against the euro. Sweden and Finland contributed 1.8 billion euros to the fund, largely because Swedish and Finnish banks had large stakes in Latvian banks, and the concern was that problems in Latvia could damage the banking systems of these two countries.

As part of the conditions for the loan, the IMF required significant change in economic policy from the Latvian government, including interest rate increases, wage cuts, sharp cutbacks in government spending, and tax increases. There was no question that these policies would push Latvia into a deep recession. The belief of the IMF, however, was that they were necessary to restore confidence in both the country's banking system and in the ability of the government to maintain the peg of the lat to the euro. Once that has been achieved, so the argument goes, conditions will improve and the country will start to grow again. Be that as it may, some Latvians reacted to the deal by rioting in the streets of Riga, the capital. Forty people were hurt, including 14 police officers, and 106 arrests were made, suggesting that the road ahead would be bumpy.[35]

Case Discussion Questions

1. What kind of crisis was Latvia experiencing in 2008, a currency crisis, banking crisis, or debt crisis?
2. If the IMF had not stepped in with support, what do you think might have occurred?
3. Could the Latvian government have headed off the 2008 crisis? What policy actions could it have to do this? What might the economic and political consequences of those actions have been?
4. What do you think the short-term consequences of the IMF policies will be for Latvia? What might the long-term consequences be?

Notes

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12 The Global Capital Market

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Describe the benefits of the global capital market.
- **LO2** Identify why the global capital market has grown so rapidly.
- **LO3** Understand the risks associated with the globalization of capital markets.
- **LO4** Compare and contrast the benefits and risks associated with the Eurocurrency market, the global bond market, and the global equity market.
- **LO5** Understand how foreign exchange risks impacts upon the cost of capital.

Global Capital Markets in Crisis

In 2008 a serious crisis swept through global capital markets that very nearly froze the financial pipes that lubricate the wheels of the global economy. Unseen to most people, investment institutions, banks, and corporations around the world routinely lend and borrow trillions of dollars between themselves. Most banks and corporations issue *unsecured* notes known as *commercial paper* with a fixed maturity of between 1 and 270 days. This is a way for those firms to get access to cash to meet short-term obligations, including meeting payroll, making investments, paying suppliers, or financing other borrowings. Because the notes are unsecured, and thus not backed by any specific assets, only banks and corporations with excellent credit ratings will be able to sell their commercial paper at a reasonable price. Typically, this price is set with reference to the London Interbank Offered Rate (LIBOR). Calculated daily for 10 currencies based on a survey of 12 to 16 banks for each currency. As the name suggests, the LIBOR is the rate at which banks lend to each other. In normal times, the LIBOR rate is very close to the rate charged by national central banks, such as the U.S. Federal Reserve for the dollar.

In the fall of 2008, however, the times were anything but normal. Earlier in the year, banks in several countries had started to run into trouble as it became clear that the value of the mortgage-backed securities that they held was collapsing. This was due to a fall in housing prices, and rising default rates on mortgages, most notably in the United Sates and Britain, where aggressive lenders had written increasingly risky mortgages over the preceding few years. These mortgages were typically bundled into securities and then sold to other financial institutions. Also, many institutions held complex derivatives, the value of which was tied to the underlying value of mortgage-backed securities. Now these institutions were facing large write-offs on their portfolios of mortgage-backed securities and the associated derivatives. One of these institutions, Lehman Brothers, had taken particularly aggressive positions in the market for mortgage-backed securities. In September 2008 the firm collapsed into bankruptcy after the U.S. government decided not to step in and save the company. The government's reasoning was that it did not want to save a management team that had made very bad investment decisions. Market forces, they believed, should be allowed to operate.

However, the bankruptcy of Lehman had unforeseen consequences. It sent shock waves through the global financial markets. In effect, the U.S. government had



stated it was prepared to let large financial institutions fail. Immediately, banks reduced their short-term loans. They did this for two reasons. First, they felt a need to hoard cash because they no longer knew the value of the mortgage-backed securities they held on their own balance sheets. Second, they were afraid to lend to other banks because those banks might fail and they might not get their money back.

As a result, LIBOR rates quickly spiked. The dollar rate, for example, had been 0.2 percent above the rate on three-month U.S. Treasury bills in 2007, which is a normal spread. However, the spread increased to 3.3 percent by late 2008, raising the cost of short-term borrowing some 16-fold. Many corporations found that they could not raise capital at a reasonable price. Money market funds, which in normal times are large buyers of commercial paper, fled to ultra-safe assets, such as U.S. Treasury bills. This pushed the yield on three-month Treasury bills down to historic lows, and also led to a sharp rise in the value of the U.S. dollar. In essence, the financial plumbing of the global economy was rapidly freezing up. If nothing was done about it, many firms could become insolvent and a wave of bankruptcies could sweep around the globe, plunging the world into a serious recession, or even a depression.

At this point several national governments stepped into the breach. In October 2008, the U.S. Federal Reserve entered the commercial paper market, setting up a fund to purchase commercial paper at rates close to the rates for U.S. Treasuries. Central Banks in Japan, Britain, and the European Union took similar action. Once participants in the global capital markets saw that national governments were willing to enter the commercial paper market, they too started to ease their lending restrictions, and LIBOR rates stated to fall again. The U.S. government established the Troubled Asset Relief Program (TARP) allowing the U.S. Treasury to purchase or insure up to $700 billion in "troubled assets." Under TARP the government began to inject capital into troubled banks by purchasing assets from them that were difficult to value, such as mortgage-backed securities. This signaled there would be no more bankruptcies such as Lehman's. This too helped to unfreeze the market for commercial paper. A major crisis had been adverted, but only just. (Although the $700 billion price tag for TARP stunned people, most of the money lent to banks under TARP was quickly paid back with interest, and by late 2010 estimates suggest that the total cost to the taxpayer would be less than $25 billion.)[1]

Introduction

The opening case illustrates just how interconnected capital markets have become in our global age. Banks and corporations borrow money to meet their short-term needs by issuing commercial paper. The market for commercial paper is a truly global capital market with interest rates set by the London Interbank Offered Rate (LIBOR) and market participants from all over the world entering into exchanges with each other. Its efficient operation is vital for the functioning of the global economy. Without it, banks will stop lending, corporations will not be able to get access to the working capital they need to pay their bills, business will contract, payroll may not be meet, suppliers may not be paid, and international trade will stall. This situation, previously unimaginable, very nearly occurred in the fall of 2008 as the global market for short-term commercial paper seized up following the bankruptcy of Lehman Brothers in the United States. The resulting financial contagion, which rapidly spread around the globe, was halted by quick action from several national governments, which effectively stepped in to add new liquidity to this marketplace.

This chapter looks at the global market for capital. We begin by studying the benefits associated with the globalization of capital markets. This is followed by a more detailed look at the growth of the international capital market and the macroeconomic risks associated with such growth. Next, we review three important segments of the global capital market: the Eurocurrency market, the international bond market, and the international equity market. As usual, we close the chapter by pointing out some of the implications for the practice of international business.

LO1 Benefits of the Global Capital Market

Although this section is about the global capital market, it opens by discussing the functions of a generic capital market. Then we will look at the limitations of domestic capital markets and discuss the benefits of using global capital markets.

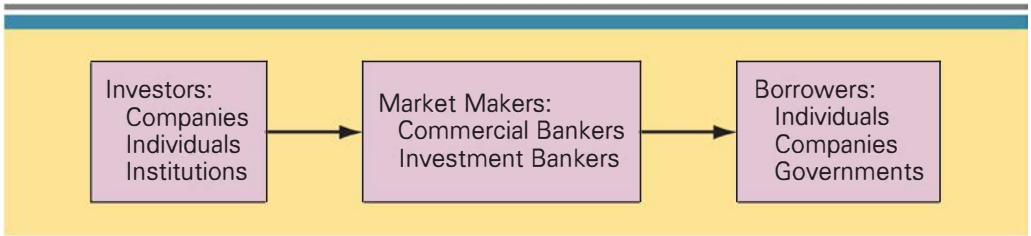
FUNCTIONS OF A GENERIC CAPITAL MARKET

Capital markets bring together those who want to invest money and those who want to borrow money (see Figure 12.1). Those who want to invest money include corporations with surplus cash, individuals, and nonbank financial institutions (e.g., pension funds, insurance companies). Those who want to borrow money include individuals, companies, and governments. Between these two groups are the market makers. Market makers are the financial service companies that connect investors and borrowers, either directly or indirectly. They include commercial banks (e.g., Citicorp, U.S. Bank) and investment banks (e.g., Goldman Sachs).

Commercial banks perform an indirect connection function. They take cash deposits from corporations and individuals and pay them a rate of interest in return. They then lend that money to borrowers at a higher rate of interest, making a profit from the difference in interest rates (commonly referred to as the interest rate spread). Investment banks perform a direct connection function. They bring investors and borrowers together and charge commissions for doing so. For example, Goldman Sachs may act as a stockbroker for an individual who wants to invest some money. Its personnel will advise her as to the most attractive purchases and buy stock on her behalf, charging a fee for the service.

FIGURE 12.1

The Main Players in the Generic Capital Market



Capital market loans to corporations are either equity loans or debt loans. An equity loan is made when a corporation sells stock to investors. The money the corporation receives in return for its stock can be used to purchase plants and equipment, fund R&D projects, pay wages, and so on. A share of stock gives its holder a claim to a firm's profit stream. Ultimately, the corporation honors this claim by paying dividends to the stockholders (although many fast-growing young corporations do not start to issue dividends until the business has matured and growth rate slows). The amount of the dividends is not fixed in advance. Rather, it is determined by management based on how much profit the corporation is making. Investors purchase stock both for their dividend yield and in anticipation of gains in the price of the stock, which in theory reflects future dividend yields. Stock prices increase when a corporation is projected to have greater earnings in the future, which increases the probability that it will raise future dividend payments.

A debt loan requires the corporation to repay a predetermined portion of the loan amount (the sum of the principal plus the specified interest) at regular intervals regardless of how much profit it is making. Management has no discretion as to the amount it will pay investors. Debt loans include cash loans from banks and funds raised from the sale of corporate bonds to investors. When an investor purchases a corporate bond, he purchases the right to receive a specified fixed stream of income from the corporation for a specified number of years (i.e., until the bond maturity date). The maturity period of debt loans vary from the very long term, such as 20 years, to extremely short-term loans, including those with a maturity of just one day.

ATTRACTIONS OF THE GLOBAL CAPITAL MARKET

A global capital market benefits both borrowers and investors. It benefits borrowers by increasing the supply of funds available for borrowing and by lowering the cost of capital. It benefits investors by providing a wider range of investment opportunities, thereby allowing them to build portfolios of international investments that diversify their risks.

The Borrower's Perspective: Lower Cost of Capital

In a purely domestic capital market, the pool of investors is limited to residents of the country. This places an upper limit on the supply of funds available to borrowers. In other words, the liquidity of the market is limited. A global capital market, with its much larger pool of investors, provides a larger supply of funds for borrowers to draw on.

Perhaps the most important drawback of the limited liquidity of a purely domestic capital market is that the cost of capital tends to be higher than it is in a global market. The cost of capital is the price of borrowing money, which is the rate of return that borrowers must pay investors. This is the interest rate on debt loans and the dividend yield and expected capital gains on equity loans. In a purely domestic market, the limited pool of investors implies that borrowers must pay more to persuade investors to lend them their money. The larger pool of investors in an international market implies that borrowers will be able to pay less.

The argument is illustrated in Figure 12.2, using Deutsche Telekom as an example (see the Management Focus for details). Deutsche Telekom raised over $13 billion by simultaneously offering shares for sales in Frankfurt, New York, London, and Tokyo. The vertical axis in Figure 12.2 is the cost of capital (the price of borrowing money) and the horizontal axis is the amount of money available at varying interest rates. DD is the Deutsche Telekom demand curve for borrowings. Note that the Deutsche Telekom demand for funds varies with the cost of capital; the lower the cost of capital, the more money Deutsche Telekom will borrow. (Money is just like anything else; the lower its price, the more of it people can afford.) SS_G is the supply curve of funds available in the German capital market, and SS_I represents the funds available in the global capital market. Note that Deutsche Telekom can borrow more funds more cheaply on the global capital market. As Figure 12.2 illustrates, the greater pool of resources in the global capital market—the greater liquidity—both lowers the cost of capital and increases the amount Deutsche Telekom can borrow. Thus, the advantage of a global capital market to borrowers is that it lowers the cost of capital.



MANAGEMENT FOCUS

Deutsche Telekom Taps the Global Capital Market

Based in the world's third-largest industrial economy, Deutsche Telekom is one of the world's largest telephone companies. Until late 1996, the company was wholly owned by the German government. However, in the mid-1990s, the German government formulated plans to privatize the utility, selling shares to the public. The privatization effort was driven by two factors: (1) a realization that state-owned enterprises tend to be inherently inefficient, and (2) the impending deregulation of the European Union telecommunications industry in 1998, which promised to expose Deutsche Telekom to foreign competition for the first time. Deutsche Telekom realized that, to become more competitive, it needed massive investments in new telecommunications infrastructure, including fiber optics and wireless, lest it start losing share in its home market to more efficient competitors such as AT&T and British Telecom after 1998. Financing such investments from state sources would have been difficult even under the best of circumstances and almost impossible in the late 1990s, when the German government was trying to limit its budget deficit to meet the criteria for membership in the European monetary union. With the active encouragement of the government, Deutsche Telekom hoped to finance its investments in capital equipment through the sale of shares to the public.

From a financial perspective, the privatization looked anything but easy. In 1996, Deutsche Telekom was valued at about $60 billion. If it maintained this valuation as a private company, it would dwarf all others listed on the German stock market. However, many analysts doubted there was anything close to $60 billion available in Germany for investment in Deutsche Telekom stock. One problem was that there was no tradition of retail stock investing in Germany. In 1996, only 1 in 20 German citizens owned shares, compared with 1 in every 4 or 5 in the United States and Britain. This lack of retail interest in stock ownership makes for a relatively illiquid stock market. Nor did banks, the traditional investors in company stocks in Germany, seem enthused about underwriting such a massive privatization effort. A further problem was that a wave of privatizations was already sweeping through Germany and the rest of Europe, so Deutsche Telekom would have to compete with many other state-owned enterprises for investors' attention. Given these factors, probably the only way that Deutsche Telekom could raise $60 billion through the German capital market would have been by promising investors a dividend yield that would raise the company's cost of capital above levels that could be serviced profitably.

Deutsche Telekom managers concluded they had to privatize the company in stages and sell a substantial portion of Deutsche Telekom stock to foreign investors. The company's plans called for an initial public offering (IPO) of 713 million shares of Deutsche Telekom stock, representing 25 percent of the company's total value, for about $18.50 per share. With a total projected value in excess of $13 billion, even this "limited" sale of Deutsche Telekom represented the largest IPO in European history and the second largest in the world after the 1987 sale of shares in Japan's telephone monopoly, NTT, for $15.6 billion. Concluding there was no way the German capital market could absorb even this partial sale of Deutsche Telekom equity, the managers of the company decided to simultaneously list shares and offer them for sale in Frankfurt (where the German stock exchange is located), London, New York, and Tokyo, attracting investors from all over the world. The IPO was successfully executed in November 1996 and raised $13.3 billion for the company.[2]

Problems of limited liquidity are not restricted to less developed nations, which naturally tend to have smaller domestic capital markets. In recent decades, even very large enterprises based in some of the world's most advanced industrialized nations have tapped the international capital markets in their search for greater liquidity and a lower cost of capital, such as Germany's Deutsche Telekom.[3]

The Investor's Perspective: Portfolio Diversification

By using the global capital market, investors have a much wider range of investment opportunities than in a purely domestic capital market. The most significant consequence

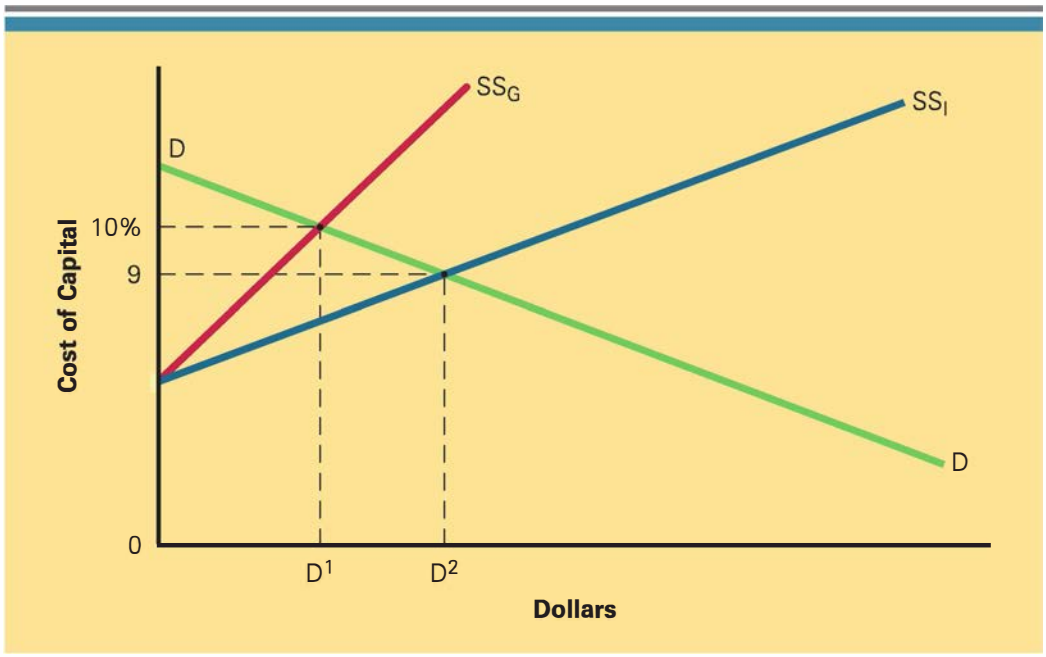


FIGURE 12.2

Market Liquidity and the Cost of Capital

of this choice is that investors can diversify their portfolios internationally, thereby reducing their risk to less than what could be achieved in a purely domestic capital market. We will consider how this works in the case of stock holdings, although the same argument could be made for bond holdings.

Consider an investor who buys stock in a biotech firm that has not yet produced a new product. Imagine the price of the stock is very volatile—investors are buying and selling the stock in large numbers in response to information about the firm's prospects. Such stocks are risky investments; investors may win big if the firm produces a marketable product, but investors may also lose all their money if the firm fails to come up with a product that sells. Investors can guard against the risk associated with holding this stock by buying other firms' stocks, particularly those weakly or negatively correlated with the biotech stock. By holding a variety of stocks in a diversified portfolio, the losses incurred when some stocks fail to live up to their promises are offset by the gains enjoyed when other stocks exceed their promise.

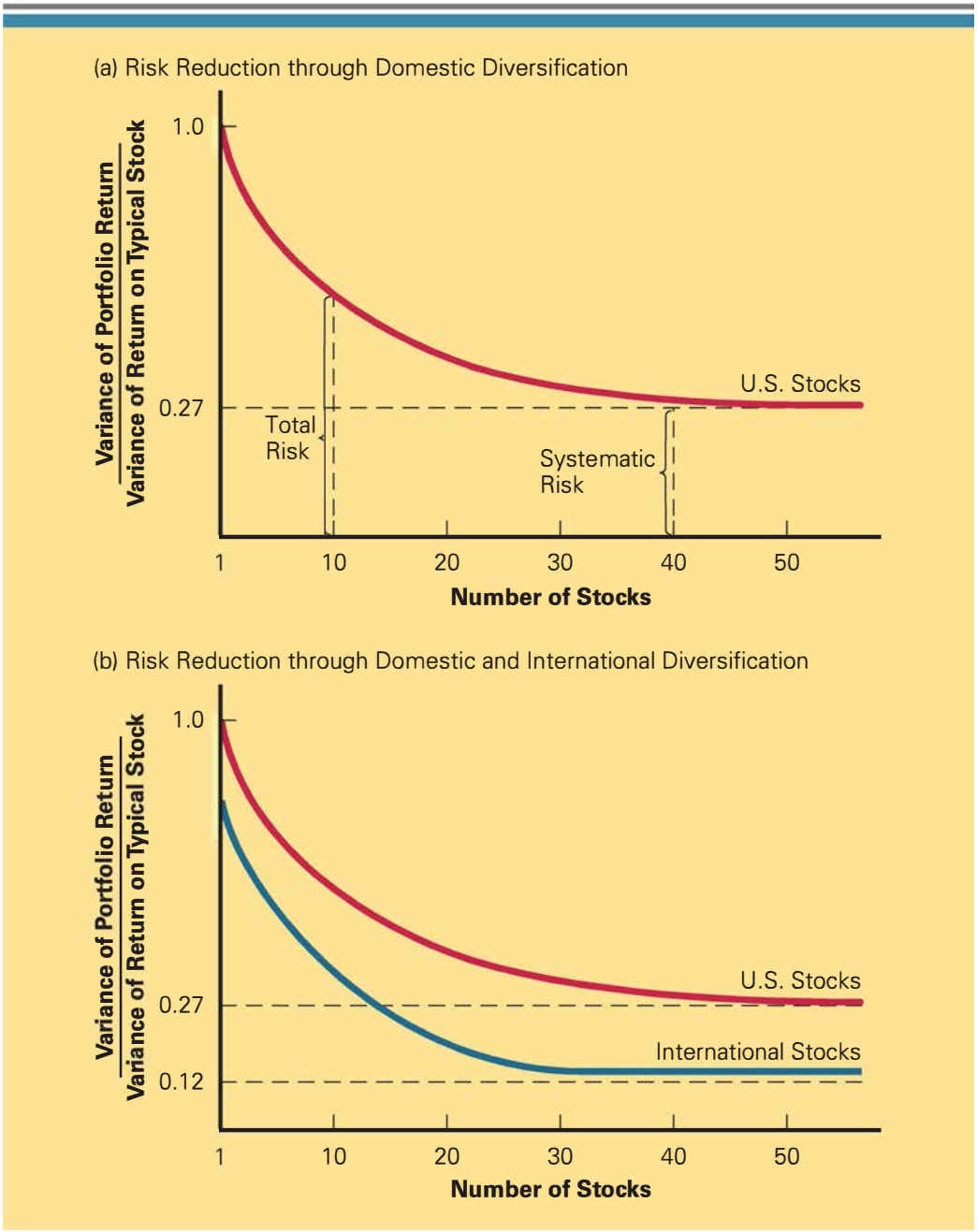
As an investor increases the number of stocks in her portfolio, the portfolio's risk declines. At first this decline is rapid. Soon, however, the rate of decline falls off and asymptotically approaches the systematic risk of the market. Systematic risk refers to movements in a stock portfolio's value that are attributable to macroeconomic forces affecting all firms in an economy, rather than factors specific to an individual firm. The systematic risk is the level of nondiversifiable risk in an economy. Figure 12.3 illustrates this relationship for the United States using data from a classic study by Solnik.[4] His data suggested that a fully diversified U.S. portfolio is only about 27 percent as risky as a typical individual stock.

By diversifying a portfolio internationally, an investor can reduce the level of risk even further because the movements of stock market prices across countries are not perfectly correlated. For example, one study looked at the correlation between three stock market indexes. The Standard & Poor's 500 (S&P 500) summarized the movement of large U.S. stocks. The Morgan Stanley Capital International Europe, Australia, and Far East Index (EAFE) summarized stock market movements in other developed nations. The third index, the International Finance Corporation Global Emerging Markets Index (IFC), summarized stock market movements in less developed "emerging economies." From 1981 to 1994, the correlation between the S&P

FIGURE 12.3

Risk Reduction Through Portfolio Diversification

Source: B. Solnik, "Why Not Diversify Internationally Rather Than Domestically?" Adapted with permission from *Financial Analysts Journal*, July/August 1974, p. 17. Copyright 1974. Financial Analysts Federation, Charlottesville, VA. All rights reserved.



500 and EAFE indexes was 0.45, suggesting they moved together only about 20 percent of the time (i.e., 0.45 × 0.45 = 0.2025). The correlation between the S&P 500 and IFC indexes was even lower at 0.32, suggesting they moved together only a little over 10 percent of the time.[5] Other studies have confirmed that despite casual observations, different national stock markets appear to be only moderately correlated. One study found that between 1972 and 2000 the average pair-wise correlation between the world's four largest equity markets in the United States, United Kingdom, Germany, and Japan was 0.475, suggesting that these markets moved in tandem only about 22 percent of the time (0.475 × 0.472 = 0.22 or 22 percent of shared variance).[6]

The relatively low correlation between the movement of stock markets in different countries reflects two basic factors. First, countries pursue different macroeconomic policies and face different economic conditions, so their stock markets respond to

different forces and can move in different ways. For example, in 1997, the stock markets of several Asian countries, including South Korea, Malaysia, Indonesia, and Thailand, lost more than 50 percent of their value in response to the Asian financial crisis, while at the same time the S&P 500 increased in value by over 20 percent. Second, different stock markets are still somewhat segmented from each other by capital controls—that is, by restrictions on cross-border capital flows (although as noted earlier, such restrictions are declining rapidly). The most common restrictions include limits on the amount of a firm's stock that a foreigner can own and limits on the ability of a country's citizens to invest their money outside that country. For example, until recently it was difficult for foreigners to own more than 30 percent of the equity of South Korean enterprises. Tight restrictions on capital flows make it very hard for Chinese citizens to take money out of their country and invest it in foreign assets. Such barriers to cross-border capital flows limit the ability of capital to roam the world freely in search of the highest risk-adjusted return. Consequently, at any one time, there may be too much capital invested in some markets and too little in others. This will tend to produce differences in rates of return across stock markets.[7] The implication is that by diversifying a portfolio to include foreign stocks, an investor can reduce the level of risk below that incurred by holding just domestic stocks.

Figure 12.3 also illustrates the relationship between international diversification and risk found in the classic study by Bruno Solnik.[8] According to the figure, a fully diversified portfolio that contains stocks from many countries is less than half as risky as a fully diversified portfolio that contains only U.S. stocks. Solnik found that a fully diversified portfolio of international stocks is only about 12 percent as risky as a typical individual stock, whereas a fully diversified portfolio of U.S. stocks is about 27 percent as risky as a typical individual stock.

There is a perception, increasingly common among investment professionals, that the growing integration of the global economy and the emergence of the global capital market have increased the correlation between different stock markets, reducing the benefits of international diversification.[9] Today, it is argued, if the U.S. economy enters a recession, and the U.S. stock market declines rapidly, other markets follow suit. Indeed, this is what seems to have occurred in 2008 and 2009 as the financial crisis that started in the United States swept around the world. A study by Solnik suggests there may be some truth to this assertion, but the rate of integration is not occurring as rapidly as the popular perception would lead one to believe. Solnik and his associate looked at the correlation between 15 major stock markets in developed countries between 1971 and 1998. They found that on average, the correlation of monthly stock market returns increased from 0.66 in 1971 to 0.75 in 1998, indicating some convergence over time, but that "the regression results were weak," which suggests that this "average" relationship was not strong, and that there was considerable variation among countries.[10] Similarly, a study published in 2005 confirmed this basic finding, suggesting that even today, most of the time a portfolio equally diversified across all available markets can reduce portfolio risk to about 35 percent of the volatility associated with a single market (i.e., a 65 percent reduction in risk).[11]

The implication here is that international portfolio diversification can still reduce risk. Moreover, the correlation between stock market movements in developed and emerging markets seems to be lower, and the rise of stock markets in developing nations, such as China, has given international investors many more opportunities for international portfolio diversification.[12]

The risk-reducing effects of international portfolio diversification would be greater were it not for the volatile exchange rates associated with the current floating exchange rate regime. Floating exchange rates introduce an additional element of risk into investing in foreign assets. As we have said repeatedly, adverse exchange rate movements can transform otherwise profitable investments into unprofitable investments. The uncertainty engendered by volatile exchange rates may be acting as a brake on the otherwise rapid growth of the international capital market.

LO2

GROWTH OF THE GLOBAL CAPITAL MARKET

According to data from the Bank for International Settlements, the global capital market is growing at a rapid pace.[13] By late 2010 the stock of cross-border bank loans stood at $32,430 billion, compared to $7,859 billion in 2000 and $3,600 billion in 1990. There was $26,613 billion in outstanding international bonds in late 2010, up from $5,908 billion in 2000 and $3,515 billion in 1997. International equity offerings for 2009 were $750 billion, compared to $90 billion in 1997 and some $18 billion in 1990. All these figures were records. What factors allowed the international capital market to bloom in the 1980s, 1990s, and 2000s? There seem to be two answers—advances in information technology and deregulation by governments.

Information Technology

Financial services is an information-intensive industry. It draws on large volumes of information about markets, risks, exchange rates, interest rates, creditworthiness, and so on. It uses this information to make decisions about what to invest where, how much to charge borrowers, how much interest to pay to depositors, and the value and riskiness of a range of financial assets including corporate bonds, stocks, government securities, and currencies.

Because of this information intensity, the financial services industry has been revolutionized more than any other industry by advances in information technology since the 1970s. The growth of international communications technology has facilitated instantaneous communication between any two points on the globe. At the same time, rapid advances in data processing capabilities have allowed market makers to absorb and process large volumes of information from around the world. According to one study, because of these technological developments, the real cost of recording, transmitting, and processing information fell by 95 percent between 1964 and 1990.[14] With the rapid rise of the Internet and the massive increase in computing power that we have seen since 1990, it seems likely that the cost of recording, transmitting, and processing information has fallen by a similar amount since 1990 and is now trivial.

Such developments have facilitated the emergence of an integrated international capital market. It is now technologically possible for financial services companies to engage in 24-hour-a-day trading, whether it is in stocks, bonds, foreign exchange, or any other financial asset. Due to advances in communications and data processing technology, the international capital market never sleeps. San Francisco closes one hour before Tokyo opens, but during this period trading continues in New Zealand.

The integration facilitated by technology has a dark side.[15] "Shocks" that occur in one financial center now spread around the globe very quickly. The collapse of U.S. stock prices on the notorious Black Monday of October 19, 1987, immediately triggered similar collapses in all the world's major stock markets, wiping billions of dollars off the value of corporate stocks worldwide. Similarly, the Asian financial crisis of 1997 sent shock waves around the world and precipitated a sell-off in world stock markets, although the effects of the shock were short lived. And as discussed in the opening case, the financial crisis that began in the United States in 2008 quickly spread around the globe. However, most market participants would argue that the benefits of an integrated global capital market far outweigh any potential costs. Moreover, despite the fact that shocks in national financial markets do seem to spill over into other markets, on average the correlation between movements in national equity markets remains relatively low, suggesting that such shocks may have a relatively moderate long-term impact outside of their home market.[16]

Deregulation

In country after country, financial services has historically been the most tightly regulated of all industries. Governments around the world have traditionally kept other countries' financial service firms from entering their capital markets. In some cases, they have also restricted the overseas expansion of their domestic financial services firms. In many countries, the law has also segmented the domestic financial services industry. In the United States, for example, until the late 1990s commercial banks were prohibited

from performing the functions of investment banks, and vice versa. Historically, many countries have limited the ability of foreign investors to purchase significant equity positions in domestic companies. They have also limited the amount of foreign investment that their citizens could undertake. In the 1970s, for example, capital controls made it very difficult for a British investor to purchase American stocks and bonds.

Many of these restrictions have been crumbling since the early 1980s. In part, this has been a response to the development of the Eurocurrency market, which from the beginning was outside of national control. (This is explained later in the chapter.) It has also been a response to pressure from financial services companies, which have long wanted to operate in a less regulated environment. Increasing acceptance of the free market ideology associated with an individualistic political philosophy also has a lot to do with the global trend toward the deregulation of financial markets (see Chapter 2). Whatever the reason, deregulation in a number of key countries has undoubtedly facilitated the growth of the international capital market.

The trend began in the United States in the late 1970s and early 80s with a series of changes that allowed foreign banks to enter the U.S. capital market and domestic banks to expand their operations overseas. In Great Britain, the so-called Big Bang of October 1986 removed barriers that had existed between banks and stockbrokers and allowed foreign financial service companies to enter the British stock market. Restrictions on the entry of foreign securities houses have been relaxed in Japan, and Japanese banks are now allowed to open international banking facilities. In France, the "Little Bang" of 1987 opened the French stock market to outsiders and to foreign and domestic banks. In Germany, foreign banks are now allowed to lend and manage foreign euro issues, subject to reciprocity agreements.[17] All of this has enabled financial services companies to transform themselves from primarily domestic companies into global operations with major offices around the world—a prerequisite for the development of a truly international capital market. As we saw in Chapter 6, in late 1997 the World Trade Organization brokered a deal that removed many of the restrictions on cross-border trade in financial services. This deal facilitated further growth in the size of the global capital market.

In addition to the deregulation of the financial services industry, many countries beginning in the 1970s started to dismantle capital controls, loosening both restrictions on inward investment by foreigners and outward investment by their own citizens and corporations. By the 1980s, this trend spread from developed nations to the emerging economies of the world as countries across Latin America, Asia, and Eastern Europe started to dismantle decades-old restrictions on capital flows.

The trends toward deregulation of financial services and removal of capital controls were still firmly in place until 2008. However, the global financial crisis of 2008–2009 prompted many to wonder if deregulation had gone too far, and it focused attention on the need for new regulations to govern certain sectors of the financial services industry, including the hedge funds, which operate largely outside of existing regulatory boundaries. (**Hedge funds** are private investment funds that position themselves to make "long bets" on assets that they think will increase in value and "short bets" on assets that they think will decline in value.) Given the benefits associated with the globalization of capital, notwithstanding the current contraction, over the long term the growth of the global capital market can be expected to continue. While most commentators see this as a positive development, some believe the globalization of capital holds inherent serious risks.

GLOBAL CAPITAL MARKET RISKS LO3

Some analysts are concerned that due to deregulation and reduced controls on cross-border capital flows, individual nations are becoming more vulnerable to speculative capital flows. They see this as having a destabilizing effect on national economies.[18] Harvard economist Martin Feldstein, for example, has argued that most of the capital that moves internationally is pursuing temporary gains, and it shifts in and out of countries as quickly as conditions change.[19] He distinguishes between this short-term capital, or "hot money," and "patient money" that

COUNTRY FOCUS

Did the Global Capital Markets Fail Mexico?

In early 1994, soon after passage of the North American Free Trade Agreement (NAFTA), Mexico was widely admired among the international community as a shining example of a developing country with a bright economic future. Since the late 1980s, the Mexican government had pursued sound monetary, budget, tax, and trade policies. By historical standards, inflation was low, the country was experiencing solid economic growth, and exports were booming. This robust picture attracted capital from foreign investors; between 1991 and 1993, foreigners invested more than $75 billion in the Mexican economy, more than in any other developing nation.

If there was a blot on Mexico's economic report card, it was the country's growing current account (trade) deficit. Mexican exports were booming, but so were its imports. In the 1989–1990 period, the current account deficit was equivalent to about 3 percent of Mexico's gross domestic product. In 1991 it increased to 5 percent, and by 1994 it was running at an annual rate of over 6 percent. Bad as this might seem, it is not unsustainable and should not bring an economy crashing down. The United States has been running a current account deficit for decades with apparently little in the way of ill effects. A current account deficit will not be a problem for a country as long as foreign investors take the money they earn from trade with that country and reinvest it within the country. This has been the case in the United States for years, and during the early 1990s, it was occurring in Mexico too. Thus, companies such as Ford took the pesos they earned from exports to Mexico and reinvested those funds in productive capacity in Mexico, building auto plants to serve the future needs of the Mexican market and to export elsewhere.

Unfortunately for Mexico, much of the $25 billion annual inflow of capital it received during the early 1990s was not the kind of patient long-term money that Ford was putting into Mexico. Rather, according to economist Martin Feldstein, much of the inflow was short-term capital that could flee if economic conditions changed for the worse. This is what seems to have occurred. In February 1994, the U.S. Federal Reserve began to increase U.S. interest rates. This led to a rapid fall in U.S. bond prices. At the same time, the yen began to appreciate sharply against the U.S. dollar. These events resulted in large losses for many managers of short-term capital, such as hedge fund managers and banks, who had been betting on exactly the

would support long-term cross-border capital flows. To Feldstein, patient money is still relatively rare, primarily because although capital is free to move internationally, its owners and managers still prefer to keep most of it at home. Feldstein supports his arguments with statistics that demonstrate that although vast amounts of money flows through the foreign exchange markets every day, "when the dust settles, most of the savings done in each country stays in that country."[20] Feldstein argues that the lack of patient money is due to the relative paucity of information that investors have about foreign investments. In his view, if investors had better information about foreign assets, the global capital market would work more efficiently and be less subject to short-term speculative capital flows. Feldstein claims that Mexico's economic problems in the mid-1990s were the result of too much hot money flowing in and out of the country and too little patient money. This example is reviewed in detail in the accompanying Country Focus.

A lack of information about the fundamental quality of foreign investments may encourage speculative flows in the global capital market. Faced with a lack of quality information, investors may react to dramatic news events in foreign nations and pull their money out too quickly. Despite advances in information technology, it is still difficult for investors to get access to the same quantity and quality of information about foreign investment opportunities that they can get about domestic investment opportunities. This information gap is exacerbated by different accounting conventions in different countries, which makes the direct comparison of cross-border investment opportunities difficult for all but the most sophisticated investor (see Chapter 19 for details). For example, historically German accounting principles have been different from those found in the United States and presented quite a different picture of the health of a company. Thus, when the Germany company Daimler-Benz translated its German financial accounts into U.S.-style accounts in 1993, as it had to do to be listed on the New York Stock Exchange, it found

opposite happening. Many hedge funds had been betting that interest rates would fall, bond prices would rise, and the dollar would appreciate against the yen.

Faced with large losses, money managers tried to reduce the riskiness of their portfolios by pulling out of risky situations. About the same time, events took a turn for the worse in Mexico. An armed uprising in the southern state of Chiapas, the assassination of the leading candidate in the presidential election campaign, and an accelerating inflation rate all helped produce a feeling that Mexican investments were riskier than had been assumed. Money managers began to pull many of their short-term investments out of the country.

As hot money flowed out, the Mexican government realized it could not continue to count on capital inflows to finance its current account deficit. The government had assumed the inflow was mainly composed of patient, long-term money. In reality, much of it appeared to be short-term money. As money flowed out of Mexico, the Mexican government had to commit more foreign reserves to defending the value of the peso against the U.S. dollar, which was pegged at 3.5 to the dollar. Currency speculators entered the picture and began to bet against the Mexican government by selling pesos short. Events came to a head in December 1994 when the Mexican government was essentially forced by capital flows to abandon its support for the peso. Over the next month, the peso lost 40 percent of its value against the dollar, the government was forced to introduce an economic austerity program, and the Mexican economic boom came to an abrupt end.

According to Martin Feldstein, the Mexican economy was brought down not by currency speculation on the foreign exchange market, but by a lack of long-term patient money. He argued that Mexico offered, and still offers, many attractive long-term investment opportunities, but because of the lack of information on long-term investment opportunities in Mexico, most of the capital flowing into the country from 1991 to 1993 was short-term, speculative money, the flow of which could quickly be reversed. If foreign investors had better information, Feldstein argued, Mexico should have been able to finance its current account deficit from inward capital flows because patient capital would naturally gravitate toward attractive Mexican investment opportunities.[21]

that while it had made a profit of $97 million under German rules, under U.S. rules it had lost $548 million![22] However, in the 2000s there has been rapid movement toward harmonization of different national accounting standards, which is certainly improving the quality of information available to investors (see Chapter 20 for details).

Given the problems created by differences in the quantity and quality of information, many investors have yet to venture into the world of cross-border investing, and those that do are prone to reverse their decision on the basis of limited (and perhaps inaccurate) information. However, if the international capital market continues to grow, financial intermediaries likely will increasingly provide quality information about foreign investment opportunities. Better information should increase the sophistication of investment decisions and reduce the frequency and size of speculative capital flows. Although concerns about the volume of "hot money" sloshing around in the global capital market increased as a result of the Asian financial crisis, IMF research suggests there has not been an increase in the volatility of financial markets since the 1970s.[23]

The Eurocurrency Market LO4

A **Eurocurrency** is any currency banked outside of its country of origin. Eurodollars, which account for about two-thirds of all Eurocurrencies, are dollars banked outside of the United States. Other important Eurocurrencies include the Euro-yen, the Euro-pound, and the Euro-euro! The term *Eurocurrency* is actually a misnomer because a Eurocurrency can be created anywhere in the world; the persistent Euro- prefix reflects the European origin of the market. The Eurocurrency market has been an important and relatively low-cost source of funds for international businesses.

GENESIS AND GROWTH OF THE MARKET

The Eurocurrency market was born in the mid-1950s when Eastern European holders of dollars, including the former Soviet Union, were afraid to deposit their holdings of dollars in the United States lest they be seized by the U.S. government to settle U.S. residents' claims against business losses resulting from the Communist takeover of Eastern Europe.[24] These countries deposited many of their dollar holdings in Europe, particularly in London. Additional dollar deposits came from various Western European central banks and from companies that earned dollars by exporting to the United States. These two groups deposited their dollars in London banks, rather than U.S. banks, because they were able to earn a higher rate of interest (which will be explained).

The Eurocurrency market received a major push in 1957 when the British government prohibited British banks from lending British pounds to finance non-British trade, a business that had been very profitable for British banks. British banks began financing the same trade by attracting dollar deposits and lending dollars to companies engaged in international trade and investment. Because of this historical event, London became, and has remained, the leading center of Eurocurrency trading.

The Eurocurrency market received another push in the 1960s when the U.S. government enacted regulations that discouraged U.S. banks from lending to non-U.S. residents. Would-be dollar borrowers outside the United States found it increasingly difficult to borrow dollars in the United States to finance international trade, so they turned to the Eurodollar market to obtain the necessary dollar funds.

The U.S. government changed its policies after the 1973 collapse of the Bretton Woods system (see Chapter 10), removing an important impetus to the growth of the Eurocurrency market. However, another political event, the oil price increases engineered by OPEC in the 1973–74 and 1979–80 periods, gave the market another big shove. As a result of the oil price increases, the Arab members of OPEC accumulated huge amounts of dollars. They were afraid to place their money in U.S. banks or their European branches, lest the U.S. government attempt to confiscate them. (Iranian assets in U.S. banks and their European branches were frozen by President Carter in 1979 after Americans were taken hostage at the U.S. embassy in Tehran; their fear was not unfounded.) Instead, these countries deposited their dollars with banks in London, further increasing the supply of Eurodollars.

Although these various political events contributed to the growth of the Eurocurrency market, they alone were not responsible for it. The market grew because it offered real financial advantages—initially to those who wanted to deposit dollars or borrow dollars and later to those who wanted to deposit and borrow other currencies. We now look at the source of these financial advantages.

ATTRACTIONS OF THE EUROCURRENCY MARKET

The main factor that makes the Eurocurrency market attractive to both depositors and borrowers is its lack of government regulation. This allows banks to offer higher interest rates on Eurocurrency deposits than on deposits made in the home currency, making Eurocurrency deposits attractive to those who have cash to deposit. The lack of regulation also allows banks to charge borrowers a lower interest rate for Eurocurrency borrowings than for borrowings in the home currency, making Eurocurrency loans attractive for those who want to borrow money. In other words, the spread between the Eurocurrency deposit rate and the Eurocurrency lending rate is less than the spread between the domestic deposit and lending rates (see Figure 12.4). To understand why this is so, we must examine how government regulations raise the costs of domestic banking.

Domestic currency deposits are regulated in all industrialized countries. Such regulations ensure that banks have enough liquid funds to satisfy demand if large numbers of domestic depositors should suddenly decide to withdraw their money. All countries operate with certain reserve requirements. For example, each time a U.S. bank accepts a deposit in dollars, it must place some fraction of that deposit in a non-interest-bearing account at a Federal Reserve Bank as part of its required reserves. Similarly, each time a

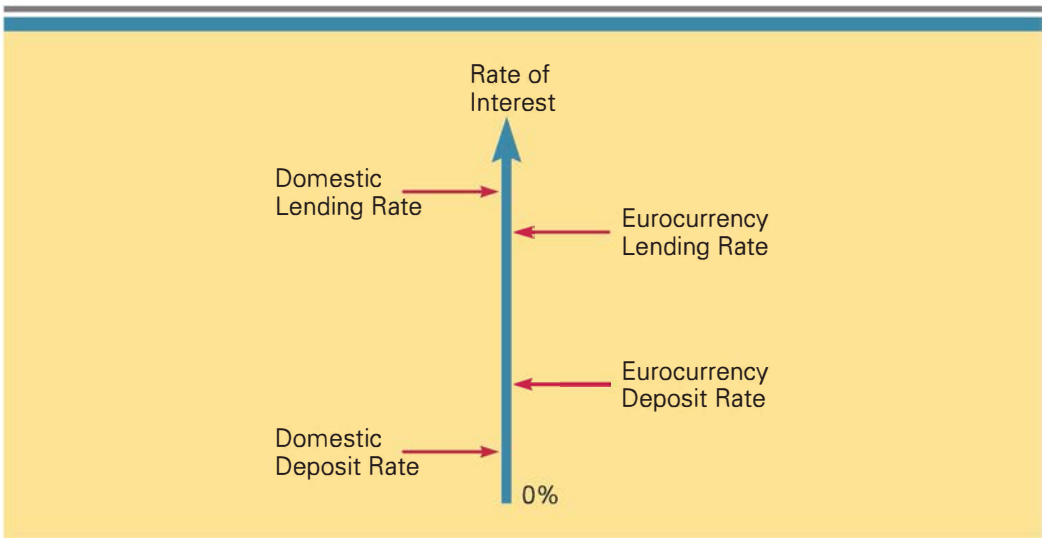


FIGURE 12.4

Interest Rate Spreads in Domestic and Eurocurrency Markets

British bank accepts a deposit in pounds sterling, it must place a certain fraction of that deposit with the Bank of England.

Banks are given much more freedom in their dealings in foreign currencies, however. For example, the British government does not impose reserve requirement restrictions on deposits of foreign currencies within its borders. Nor are the London branches of U.S. banks subject to U.S. reserve requirement regulations, provided those deposits are payable only outside the United States. This gives Eurobanks a competitive advantage.

For example, suppose a bank based in New York faces a 10 percent reserve requirement. According to this requirement, if the bank receives a $100 deposit, it can lend out no more than $90 of that and it must place the remaining $10 in a non-interest-bearing account at a Federal Reserve bank. Suppose the bank has annual operating costs of $1 per $100 of deposits and that it charges 10 percent interest on loans. The highest interest the New York bank can offer its depositors and still cover its costs is 8 percent per year. Thus, the bank pays the owner of the $100 deposit ($0.08 \times \$100 =$) $8, earns ($0.10 \times \$90 =$) $9 on the fraction of the deposit it is allowed to lend, and just covers its operating costs.

In contrast, a Eurobank can offer a higher interest rate on dollar deposits and still cover its costs. The Eurobank, with no reserve requirements regarding dollar deposits, can lend out all of a $100 deposit. Therefore, it can earn $0.10 \times \$100 = \$10$ at a loan rate of 10 percent. If the Eurobank has the same operating costs as the New York bank ($1 per $100 deposit), it can pay its depositors an interest rate of 9 percent, a full percentage point higher than that paid by the New York bank, and still cover its costs. That is, it can pay out $0.09 \times \$100 = \$9$ to its depositor, receive $10 from the borrower, and be left with $1 to cover operating costs. Alternatively, the Eurobank might pay the depositor 8.5 percent (which is still above the rate paid by the New York bank), charge borrowers 9.5 percent (still less than the New York bank charges), and cover its operating costs even better. Thus, the Eurobank has a competitive advantage vis-à-vis the New York bank in both its deposit rate and its loan rate.

Clearly, there are strong financial motivations for companies to use the Eurocurrency market. By doing so, they receive a higher interest rate on deposits and pay less for loans. Given this, the surprising thing is not that the Euromarket has grown rapidly but that it hasn't grown even faster. Why do any depositors hold deposits in their home currency when they could get better yields in the Eurocurrency market?

DRAWBACKS OF THE EUROCURRENCY MARKET

The Eurocurrency market has two drawbacks. First, when depositors use a regulated banking system, they know that the probability of a bank failure that would cause them to lose their deposits is very low. Regulation maintains the liquidity of the banking

system. In an unregulated system such as the Eurocurrency market, the probability of a bank failure that would cause depositors to lose their money is greater (although in absolute terms, still low). Thus, the lower interest rate received on home-country deposits reflects the costs of insuring against bank failure. Some depositors are more comfortable with the security of such a system and are willing to pay the price.

Second, borrowing funds internationally can expose a company to foreign exchange risk. For example, consider a U.S. company that uses the Eurocurrency market to borrow Euro-pounds—perhaps because it can pay a lower interest rate on Euro-pound loans than on dollar loans. Imagine, however, that the British pound subsequently appreciates against the dollar. This would increase the dollar cost of repaying the Euro-pound loan and thus the company's cost of capital. This possibility can be insured against by using the forward exchange market (as we saw in Chapter 10) but the forward exchange market does not offer perfect insurance. Consequently, many companies borrow funds in their domestic currency to avoid foreign exchange risk, even though the Eurocurrency markets may offer more attractive interest rates.

The Global Bond Market

The global bond market grew rapidly during the 1980s and 1990s, and has continued to do so in the new century. Bonds are an important means of financing for many companies. The most common kind of bond is a fixed-rate bond. The investor who purchases a fixed-rate bond receives a fixed set of cash payoffs. Each year until the bond matures, the investor gets an interest payment and then at maturity he gets back the face value of the bond.

International bonds are of two types: foreign bonds and Eurobonds. **Foreign bonds** are sold outside of the borrower's country and are denominated in the currency of the country in which they are issued. Thus, when Dow Chemical issues bonds in Japanese yen and sells them in Japan, it is issuing foreign bonds. Many foreign bonds have nicknames; foreign bonds sold in the United States are called Yankee bonds, foreign bonds sold in Japan are Samurai bonds, and foreign bonds sold in Great Britain are bulldogs. Companies will issue international bonds if they believe that it will lower their cost of capital. For example, during the late 1990s and early 2000s many companies issued Samurai bonds in Japan to take advantage the very low interest rates in Japan. In early 2001, 10-year Japanese government bonds yielded 1.24 percent, compared with 5 percent for comparable U.S. government bonds. Against this background, companies found that they could raise debt at a cheaper rate in Japan than the United States.

Eurobonds are normally underwritten by an international syndicate of banks and placed in countries other than the one in whose currency the bond is denominated. For example, a bond may be issued by a German corporation, denominated in U.S. dollars, and sold to investors outside of the United States by an international syndicate of banks. Eurobonds are routinely issued by multinational corporations, large domestic corporations, sovereign governments, and international institutions. They are usually offered simultaneously in several national capital markets, but not in the capital market of the country, nor to residents of the country, in whose currency they are denominated. Historically, Eurobonds accounted for the lion's share of international bond issues, but increasingly they are being eclipsed by foreign bonds.

ATTRACTIONS OF THE EUROBOND MARKET

Three features of the Eurobond market make it an appealing alternative to most major domestic bond markets; specifically,

- An absence of regulatory interference.
- Less stringent disclosure requirements than in most domestic bond markets.
- A favorable tax status.

Regulatory Interference

National governments often impose controls on domestic and foreign issuers of bonds denominated in the local currency and sold within their national boundaries. These controls tend to raise the cost of issuing bonds. However, government limitations are generally less stringent for securities denominated in foreign currencies and sold to holders of those foreign currencies. Eurobonds fall outside of the regulatory domain of any single nation. As such, they can often be issued at a lower cost to the issuer.

Disclosure Requirements

Eurobond market disclosure requirements tend to be less stringent than those of several national governments. For example, if a firm wishes to issue dollar-denominated bonds within the United States, it must first comply with SEC disclosure requirements. The firm must disclose detailed information about its activities, the salaries and other compensation of its senior executives, stock trades by its senior executives, and the like. In addition, the issuing firm must submit financial accounts that conform to U.S. accounting standards. For non-U.S. firms, redoing their accounts to make them consistent with U.S. standards can be very time consuming and expensive. Therefore, many firms have found it cheaper to issue Eurobonds, including those denominated in dollars, than to issue dollar-denominated bonds within the United States.

Favorable Tax Status

Before 1984, U.S. corporations issuing Eurobonds were required to withhold for U.S. income tax up to 30 percent of each interest payment to foreigners. This did not encourage foreigners to hold bonds issued by U.S. corporations. Similar tax laws were operational in many countries at that time, and they limited market demand for Eurobonds. U.S. laws were revised in 1984 to exempt from any withholding tax foreign holders of bonds issued by U.S. corporations. As a result, U.S. corporations found it feasible for the first time to sell Eurobonds directly to foreigners. Repeal of the U.S. laws caused other governments—including those of France, Germany, and Japan—to liberalize their tax laws likewise to avoid outflows of capital from their markets. The consequence was an upsurge in demand for Eurobonds from investors who wanted to take advantage of their tax benefits.

The Global Equity Market

Historically substantial regulatory barriers separated national equity markets from each other. Not only was it often difficult to take capital out of a country and invest it elsewhere, but corporations also frequently lacked the ability to list their shares on stock markets outside of their home nations. These regulatory barriers made it difficult for a corporation to attract significant equity capital from foreign investors. These barriers tumbled fast during the 1980s and 1990s. The global equity market enabled firms to attract capital from international investors, to list their stock on multiple exchanges, and to raise funds by issuing equity or debt around the world. For example, in 1994, Daimler-Benz, Germany's largest industrial company, raised $300 million by issuing new shares not in Germany, but in Singapore.[25] Similarly, in 1996 the German telecommunications provider Deutsche Telekom raised some $13.3 billion by simultaneously listing its shares for sale on stock exchanges in Frankfurt, London, New York, and Tokyo. These German companies elected to raise equity through foreign markets because they reasoned that their domestic capital market was too small to supply the requisite funds at a reasonable cost. To lower their cost of capital they tapped into the large and highly liquid global capital market.

More recently, many Chinese companies have been raising equity capital through foreign stock issues. In 2010, a record 39 Chinese companies issued stock through the New York Stock Exchange, giving them access to more capital at a lower cost than would have been possible if they had just issued stock in China.[26] Of course, the other

side of the coin is that if foreign entities are going to issue stock in New York, London, or another major foreign market, they also have to adhere to the stringent requirements for financial reporting that are common in those markets.

Although we have talked about the growth of the global equity market, strictly speaking there is no international equity market in the sense that there are international currency and bond markets. Rather, many countries have their own domestic equity markets in which corporate stock is traded. The largest of these domestic equity markets are to be found in the United States, Britain, and Japan. Although each domestic equity market is still dominated by investors who are citizens of that country and companies incorporated in that country, developments are internationalizing the world equity market. Investors are investing heavily in foreign equity markets to diversify their portfolios. Facilitated by deregulation and advances in information technology, this trend seems to be here to stay.

An interesting consequence of the trend toward international equity investment is the internationalization of corporate ownership. Today it is still generally possible to talk about U.S. corporations, British corporations, and Japanese corporations, primarily because the majority of stockholders (owners) of these corporations are of the respective nationality. However, this is changing. Increasingly, U.S. citizens are buying stock in companies incorporated abroad, and foreigners are buying stock in companies incorporated in the United States. Looking into the future, Robert Reich has mused about "the coming irrelevance of corporate nationality."[27]

A second development internationalizing the world equity market is that companies with historic roots in one nation are broadening their stock ownership by listing their stock in the equity markets of other nations. The reasons are primarily financial. Listing stock on a foreign market is often a prelude to issuing stock in that market to raise capital. The idea is to tap into the liquidity of foreign markets, thereby increasing the funds available for investment and lowering the firm's cost of capital. (The relationship between liquidity and the cost of capital was discussed earlier in the chapter.) Firms also often list their stock on foreign equity markets to facilitate future acquisitions of foreign companies. Other reasons for listing a company's stock on a foreign equity market are that the company's stock and stock options can be used to compensate local management and employees, it satisfies the desire for local ownership, and it increases the company's visibility with local employees, customers, suppliers, and bankers. Although firms based in developed nations were the first to start listing their stock on foreign exchanges, increasingly firms from developing countries who find their own growth limited by an illiquid domestic capital market are exploiting this opportunity. For example, firms from the Czech Republic have turned to the London stock exchange to raise equity capital (see the accompanying Country Focus).

LO5 Foreign Exchange Risk and the Cost of Capital

While a firm can borrow funds at a lower cost in the global capital market than in the domestic capital market, foreign exchange risk complicates this picture under a floating exchange rate regime. Adverse movements in foreign exchange rates can substantially increase the cost of foreign currency loans, which is what happened to many Asian companies during the 1997–1998 Asian financial crisis.

Consider a South Korean firm that wants to borrow 1 billion Korean won for one year to fund a capital investment project. The company can borrow this money from a Korean bank at an interest rate of 10 percent, and at the end of the year pay back the loan plus interest, for a total of W1.10 billion. Or the firm could borrow dollars from an international bank at a 6 percent interest rate. At the prevailing exchange rate of $1 = W1,000, the firm would borrow $1 million and the total loan cost would be $1.06 million, or W1.06 billion. By borrowing dollars, the firm could reduce its cost of capital by 4 percent, or W40 million. However, this saving is predicated on the assumption that during the year of the loan, the dollar/won exchange rate stays constant. Instead, imagine that

The Search for Capital in the Czech Republic

Following the collapse of communism and the shift toward a more market-oriented system, the Czech Republic initially emerged as one of the more vibrant and market-driven economies in Eastern Europe. By early 1998, however, the economic development of the Czech Republic was being held back by a shortage of capital. The problem was rooted in macroeconomic conditions and institutional problems.

On the macroeconomic front, 1997 saw a combination of adverse developments, including a rise in inflation, a growing government deficit, and a speculative attack on the Czech currency that forced the government to abandon its fixed exchange rate policy for a floating exchange rate system. After the shift to a floating exchange rate system, the Czech currency declined by about 10 percent against the German deutsche mark and more than 15 percent against the U.S. dollar. Because many internationally traded commodities, such as oil, are traded in dollars, this devaluation added fuel to the Czech Republic's inflation rate fire. The government responded by tightening monetary policy, raising interest rates to about 16 percent.

These macroeconomic problems had a predictably negative effect on the Prague stock market. The PX50, the key index of Czech shares listed on the Prague exchange, declined from around 520 to a low of 430 by June 1998. Much of the decline was due to foreign investment capital leaving the country for more attractive investment opportunities in neighboring Hungary and Poland, where macroeconomic conditions were more favorable and where local stock markets were performing better.

But that wasn't the only problem for the Prague stock market. Many Western investors had been discouraged from investing in Czech stocks by the poor reputation of the Prague stock exchange. That institution is reportedly rife with stock manipulation by insiders, insider trading that would be illegal in more developed markets, a lack of protection for minority stockholders, poor corporate reporting, and fraud. Also, most state-owned enterprises in the Czech Republic were privatized through a voucher scheme that has left the majority of shareholdings in the hands of institutions and groups that are preoccupied with maintaining control over their companies and opposed to any attempt to raise capital through new equity issues. Consequently, the Prague stock market is small and liquidity is very limited. These factors have combined to increase the cost of capital for individual Czech enterprises.

Traditionally, many Czech firms forged tight relationships with banks and borrowed money from them. However, with interest rates at 16 percent and many banks reining in credit to make up for past largesse, it was increasingly expensive for Czech companies to raise capital through borrowings. As for the Czech stock market, its poor reputation and low liquidity made it almost impossible to raise capital by issuing new shares. In mid-1997, one of the Czech Republic's most dynamic and profitable new enterprises, Bonton, a film and music company, attempted to raise $30 million to $40 million through an initial public offering on the Prague exchange. This would have been only the second IPO in the history of the Prague exchange, and the only one of any significance. A successful IPO would have helped to legitimize the market, but Bonton canceled the IPO when the Prague market declined to yearlong lows in the wake of the Asian financial crisis.

Despite all these problems, most agree that the Czech economy has a bright future. However, this future cannot be realized unless Czech companies can raise the capital to invest in the necessary plants and equipment. A number of prominent Czech companies in 1998 announced their intentions to make international equity issues. At the beginning of 1997, only two Czech companies had foreign listings, both of them large banks. However, another five significant companies sought listings on the London stock exchange in 1998. The first to list was Ceske Radiokomunikace, a state-owned radio, television, and telecommunications company that successfully raised $134 million in equity by listing Global Depository Receipts on the London exchange, increasing its equity by 36 percent and decreasing the state holding in the company to around 51 percent.[28]

the won depreciates sharply against the U.S. dollar during the year and ends the year at $1 = W1,500. (This occurred in late 1997 when the won declined in value from $1 = W1,000 to $1 = W1,500 in two months.) The firm still has to pay the international bank $1.06 million at the end of the year, but now this costs the company W1.59 billion (i.e., $1.06 = 1,500). As a result of the depreciation in the value of the won, the cost of borrowing in U.S. dollars has soared from 6 percent to 59 percent, a huge rise in the firm's cost of capital. Although this may seem like an extreme example, it happened to many South Korean firms in 1997 at the height of the Asian financial crisis. Not surprisingly, many of them were pushed into technical default on their loans.

Unpredictable movements in exchange rates can inject risk into foreign currency borrowing, making something that initially seems less expensive ultimately much more expensive. The borrower can hedge against such a possibility by entering into a forward contract to purchase the required amount of the currency being borrowed at a predetermined exchange rate when the loan comes due (see Chapter 10 for details). Although this will raise the borrower's cost of capital, the added insurance limits the risk involved in such a transaction. Unfortunately, many Asian borrowers did not hedge their dollar-denominated short-term debt, so when their currencies collapsed against the dollar in 1997, many saw a sharp increase in their cost of capital.

When a firm borrows funds from the global capital market, it must weigh the benefits of a lower interest rate against the risks of an increase in the real cost of capital due to adverse exchange rate movements. Although using forward exchange markets may lower foreign exchange risk with short-term borrowings, it cannot remove the risk. Most importantly, the forward exchange market does not provide adequate coverage for long-term borrowings.

IMPLICATIONS FOR MANAGERS



The implications of the material discussed in this chapter for international business are quite straightforward but no less important for being obvious. The growth of the global capital market has created opportunities for international businesses that wish to borrow and/or invest money. On the borrowing side, by using the global capital market, firms can often borrow funds at a lower cost than is possible in a purely domestic capital market. This conclusion holds no matter what form of borrowing a firm uses—equity, bonds, or cash loans. The lower cost of capital on the global market reflects their greater liquidity and the general absence of government regulation. Government regulation tends to raise the cost of capital in most domestic capital markets. The global market, being transnational, escapes regulation. Balanced against this, however, is the foreign exchange risk associated with borrowing in a foreign currency.

On the investment side, the growth of the global capital market is providing opportunities for firms, institutions, and individuals to diversify their investments to limit risk. By holding a diverse portfolio of stocks and bonds in different nations, an investor can reduce total risk to a lower level than can be achieved in a purely domestic setting. Once again, however, foreign exchange risk is a complicating factor.

The trends noted in this chapter seem likely to continue, with the global capital market continuing to increase in both importance and degree of integration over the next decade. Perhaps the most significant development will be the emergence of a unified capital market and common currency within the EU by the end of the decade as those countries continue toward economic and monetary union. Since Europe's capital markets are currently fragmented and relatively introspective (with the major exception of Britain's capital market), such a development could pave the way for even more rapid internationalization of the capital market in the early years of this century. If this occurs, the implications for business are likely to be positive.

CHAPTER SUMMARY

This chapter explained the functions and form of the global capital market and defined the implications of these for international business practice. This chapter made the following points:

1. The function of a capital market is to bring those who want to invest money together with those who want to borrow money.
2. Relative to a domestic capital market, the global capital market has a greater supply of funds available for borrowing, and this makes for a lower cost of capital for borrowers.
3. Relative to a domestic capital market, the global capital market allows investors to diversify portfolios of holdings internationally, thereby reducing risk.
4. The growth of the global capital market during recent decades can be attributed to advances in information technology, the widespread deregulation of financial services, and the relaxation of regulations governing cross-border capital flows.
5. A Eurocurrency is any currency banked outside its country of origin. The lack of government regulations makes the Eurocurrency market attractive to both depositors and borrowers. Due to the absence of regulation, the spread between the Eurocurrency deposit and lending rates is less than the spread between the domestic deposit and lending rates. This gives Eurobanks a competitive advantage.
6. The global bond market has two classifications: the foreign bond market and the Eurobond market. Foreign bonds are sold outside of the borrower's country and are denominated in the currency of the country in which they are issued. A Eurobond issue is normally underwritten by an international syndicate of banks and placed in countries other than the one in whose currency the bond is denominated. Eurobonds account for the lion's share of international bond issues.
7. The Eurobond market is an attractive way for companies to raise funds due to the absence of regulatory interference, less stringent disclosure requirements, and Eurobonds' favorable tax status.
8. Foreign investors are investing in other countries' equity markets to reduce risk by diversifying their stock holdings among nations.
9. Many companies are now listing their stock in the equity markets of other nations, primarily as a prelude to issuing stock in those markets to raise additional capital. Other reasons for listing stock in another country's exchange are to facilitate future stock swaps; to enable the company to use its stock and stock options for compensating local management and employees; to satisfy local ownership desires; and to increase the company's visibility among its local employees, customers, suppliers, and bankers.
10. When borrowing funds from the global capital market, companies must weigh the benefits of a lower interest rate against the risks of greater real costs of capital due to adverse exchange rate movements.
11. One major implication of the global capital market for international business is that companies can often borrow funds at a lower cost of capital in the international capital market than they can in the domestic capital market.
12. The global capital market provides greater opportunities for businesses and individuals to build a truly diversified portfolio of international investments in financial assets, which lowers risk.

Critical Thinking and Discussion Questions

1. Why has the global capital market grown so rapidly in recent decades? Do you think this growth will continue throughout the next decade? Why?
2. In 2008–2009, the world economy retrenched in the wake of a global financial crisis. Did the globalization of capital markets contribute to this crisis? If so, what can be done to stop global financial contagion in the future?
3. Reread the Country Focus on the search for capital in the Czech Republic. What are the advantages to Czech firms of listing their equity on the London stock exchange? Can you see any disadvantages?

4. A firm based in Mexico has found that its growth is restricted by the limited liquidity of the Mexican capital market. List the firm's options for raising money on the global capital market. Discuss the pros and cons of each option, and make a recommendation. How might your recommended options be affected if the Mexican peso depreciates significantly on the foreign exchange markets over the next two years?
5. Happy Company wants to raise $2 million with debt financing. The funds are needed to finance working capital, and the firm will repay them with interest in one year. Happy Company's treasurer is considering three options:
   a. Borrowing U.S. dollars from Security Pacific Bank at 8 percent.
   b. Borrowing British pounds from Midland Bank at 14 percent.
   c. Borrowing Japanese yen from Sanwa bank at 5 percent.

   If Happy borrows foreign currency, it will not cover it; that is, it will simply change foreign currency for dollars at today's spot rate and buy the same foreign currency a year later at the spot rate then in effect. Happy Company estimates the pound will depreciate by 5 percent relative to the dollar and the yen will appreciate 3 percent relative to the dollar in the next year. From which bank should Happy Company borrow?

Research Task globalEDGE globaledge.msu.edu

The Global Capital Market

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The top management team of your not-for-profit organization would like to find out more concerning socially responsible companies in Europe. Remembering the *FTSE* index company has a responsible investment index that addresses this issue, you decide to use the index's factsheet for your analysis. Evaluate the risk categories, countries, and industries represented in this index's leading companies.

Exercise 2

The *Bureau of Economic Analysis* is an agency of the U.S. Department of Commerce. It lists data about the U.S. Economic Accounts, including current investment positions and the amount of direct investment by multinational corporations in the United States and abroad. Prepare a brief report regarding the direct investments of other countries in the United States. Which are the leading countries in foreign direct investment in your report?

CLOSING CASE

Industrial and Commercial Bank of China

In October 2006, the Industrial and Commercial Bank of China, or ICBC, successfully completed the world's largest ever initial public offering (IPO), raising some $21 billion. It beat Japan's 1998 IPO of NTT DoCoMo by a wide margin to earn a place in the record books (NTT raised $18.4 billion in its IPO). The ICBC offering followed the IPOs of a number of other Chinese banks and corporations in recent years. Indeed, Chinese enterprises have been regularly tapping global capital markets for the past decade, as the Chinese have sought to fortify the balance sheets of the country's largest companies, to improve corporate governance and transparency, and to give China's industry leaders global recognition. Since 2000, Chinese companies have raised more than $100 billion from the equity markets. About half of that came in 2005 and 2006, largely from the country's biggest banks. Shares sold by Chinese companies are also accounting for a greater share of global equity sales—about 10 percent in 2006 compared to 2.8 percent in 2001, surpassing the total amount raised by companies in the world's second-largest economy, Japan.

To raise this amount of capital, Chinese corporations have been aggressively courting international investors. In the case of ICBC, it simultaneously listed its IPO shares on the Shanghai stock exchange and the Hong Kong exchange. The rationale for the Hong Kong listing was that regulations in Hong Kong are in accordance with international standards, while those in Shanghai have some way to go. By listing in Hong Kong, ICBC signaled to potential investors that it would adhere to the strict reporting and governance standards expected of the top global companies.

The ICBC listing attracted considerable interest from foreign investors, who saw it as a way to invest in the Chinese economy. ICBC has a nationwide bank network of more than 18,000, the largest in the nation. It claims 2.5 million corporate customers and 150 million personal accounts. Some 1,000 institutions from across the globe reportedly bid for shares in the IPO. Total orders from these institutions were equivalent to 40 times the amount of stock offered for sale. In other words, the offering was massively oversubscribed. Indeed, the issue generated total demand of some $430 billion, almost twice the value of Citicorp, the world's largest bank by market capitalization. The listing on Hong Kong attracted some $350 billion in orders from global investors, more than any other offering in Hong Kong's history. The domestic portion of the stock sales, through the Shanghai exchange, attracted some $80 billion in orders. This massive oversubscription enabled ICBC to raise the issuing price for its shares and reap some $2 billion more than planned.[29]

Case Discussion Questions

1. Why did ICBC feel it was necessary to issue equity in markets outside of mainland China? What are the advantages of such a move? Can you see any disadvantages?
2. What was the attraction of the ICBC listing to foreign investors? What do you think are the risks for a foreigner associated with investing in ICBC?

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Hyundai and Kia

For several years Hyundai and its affiliate Kia, Korea's fast-growing carmakers, have benefited from export-led growth. Hyundai sells 60 percent and Kia 80 percent of its production in foreign markets, particularly the United States, where they have been gaining share recently. By 2006 the two companies had about 4.3 percent of the U.S. market, and they hoped to double their market share there to 8.6 percent by 2010. Their success in foreign markets has been attributed to good product quality, reasonable design, and aggressive pricing. In the United States and EU, they price their cars below the prices of both domestic firms and the major Japanese companies such as Toyota and Honda. This low-price strategy has enabled the two affiliated companies to grow foreign sales, but their profit margins per car are low—as low as 3 percent on cars sold in the United States. This makes them very vulnerable to changes in the value of the Korean currency, the won, against the U.S. dollar.

In 2006, the won rose in value by about 7 percent against the U.S. dollar. It continued to appreciate throughout 2007, hitting a 10-year high against the dollar in October 2007. A stronger won means that Hyundai and Kia vehicles sold in the United States for dollars are recorded at a lower value when translated back into won, which has hurt the financial performance of both companies. In 2006, despite rising unit sales, profits at Hyundai fell 35 percent, and those at Kia fell some 94 percent. Kia had to sell 15 cars on average in the United States in 2006 to make the same amount of revenue and profit that it got from 14 cars in 2005. If the won continues to gain in value against the dollar over the long run, as many analysts predict, Hyundai and Kia may be forced to abandon their low-price strategy and start to raise prices in the United States.

Partly as a hedge against currency movements, Hyundai opened its first U.S. automobile plant in Montgomery, Alabama, in 2005, and also announced plans to build an engine plant close by. There is speculation that Hyundai will further expand its U.S. manufacturing presence in the near future, once the automobile market recovers from the severe slump it encountered in 2008 and 2009. Kia, too, is expanding its presence in the United States as a hedge against currency movements. In 2006 the company broke ground on a U.S. manufacturing plant in Georgia, which was scheduled to open in 2009. Although Hyundai and Kia saw their profits slump by almost 30 percent in 2008, sales of their cars held up relatively well despite the steep recession in the global auto industry. In fact, sales of their small cars in the United States actually increased in 2009, making the companies the only ones to register an improvement.[1]

Case Discussion Questions

1. Explain how the rise in the value of the Korean currency, the won, against the dollar affects the competitiveness of Hyundai and Kia exports to the United States.
2. Hyundai and Kia are both expanding their presence in the United States. How does this hedge against adverse currency movements? What other reasons might these companies have for investing in the United States? What are the drawbacks of such a strategy?
3. If Hyundai expects the value of the won to strengthen appreciably against the U.S. dollar over the next decade, should it still expand its presence in the United States?
4. In 2008 the Korean won depreciated 28 percent against the U.S. dollar. Does this imply that Hyundai and Kia were wrong to invest in the United States? How does this explain the relative strength of car sales from Hyundai and Kia in the U.S. market during early 2009?

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Anatomy of a Currency Crisis: The Collapse of the South Korean Won

In early 1997, South Korea could look back with pride on a 30-year "economic miracle" that had raised the country from the ranks of the poor and given it the world's eleventh-largest economy. By the end of 1997, the Korean currency, the won, had lost a staggering 67 percent of its value against the U.S. dollar, the South Korean economy lay in tatters, and the International Monetary Fund was overseeing a $55 billion rescue package. This sudden turn of events had its roots in investments made by South Korea's large industrial

conglomerates, or *chaebol*, during the 1990s, often at the bequest of politicians. In 1993, Kim Young-Sam, a populist politician, became president of South Korea. Mr. Kim took office during a mild recession and promised to boost economic growth by encouraging investment in export-oriented industries. He urged the *chaebol* to invest in new factories. South Korea enjoyed an investment-led economic boom in 1994–1995, but at a cost. The *chaebol*, always reliant on heavy borrowing, built up massive debts that were equivalent, on average, to four times their equity.

As the volume of investments ballooned during the 1990s, the quality of many of these investments declined significantly. The investments often were made on the basis of unrealistic projections about future demand conditions. This resulted in significant excess capacity and falling prices. An example is investments made by South Korean *chaebol* in semiconductor factories. Investments in such facilities surged in 1994 and 1995 when a temporary global shortage of dynamic random access memory chips (DRAMs) led to sharp price increases for this product. However, supply shortages had disappeared by 1996 and excess capacity was beginning to make itself felt, just as the South Koreans started to bring new DRAM factories on stream. The results were predictable; prices for DRAMs plunged and the earnings of South Korean DRAM manufacturers fell by 90 percent, which meant it was difficult for them to make scheduled payments on the debt they had acquired to build the extra capacity. The risk of corporate bankruptcy increased significantly, and not just in the semiconductor industry. South Korean companies were also investing heavily in a wide range of other industries, including automobiles and steel.

Matters were complicated further because much of the borrowing had been in U.S. dollars, as opposed to Korean won. This had seemed like a smart move at the time. The dollar/won exchange rate had been stable at around $1 = won 850. Interest rates on dollar borrowings were two to three percentage points lower than rates on borrowings in Korean won. Much of this borrowing was in the form of short-term, dollar-denominated debt that had to be paid back to the lending institution within one year. While the borrowing strategy seemed to make sense, it involved risk. If the won were to depreciate against the dollar, the size of the debt burden that South Korean companies would have to service would increase when measured in the local currency. Currency depreciation would raise borrowing costs, depress corporate earnings, and increase the risk of bankruptcy. This is exactly what happened.

By mid-1997, foreign investors had become alarmed at the rising debt levels of South Korean companies, particularly given the emergence of excess capacity and plunging prices in several areas where the companies had made huge investments, including semiconductors, automobiles, and steel. Given increasing speculation that many South Korean companies would not be able to service their debt payments, foreign investors began to withdraw their money from the Korean stock and bond markets. In the process, they sold Korean won and purchased U.S. dollars. The selling of won accelerated in mid-1997 when two of the smaller *chaebol* filed for bankruptcy, citing their inability to meet scheduled debt payments. The increased supply of won and the increased demand for U.S. dollars pushed down the price of won in dollar terms from around won 840 = $1 to won 900 = $1.

At this point, the South Korean central bank stepped into the foreign exchange market to try to keep the exchange rate above won 1,000 = $1. It used dollars that it held in reserve to purchase won. The idea was to try to push up the price of the won in dollar terms and restore investor confidence in the stability of the exchange rate. This action, however, did not address the underlying debt problem faced by South Korean companies. Against a backdrop of more corporate bankruptcies in South Korea, and the government's stated intentions to take some troubled companies into state ownership, Standard & Poor's, the U.S. credit rating agency, downgraded South Korea's sovereign debt. This caused the Korean stock market to plunge 5.5 percent, and the Korean won to fall to won 930 = $1. According to S&P, "The downgrade of . . . ratings reflects the escalating cost to the government of supporting the country's ailing corporate and financial sectors."

The S&P downgrade triggered a sharp sale of the Korean won. In an attempt to protect the won against what was fast becoming a classic bandwagon effect, the South Korean central bank raised short-term interest rates to over 12 percent, more than double the inflation rate. The bank also stepped up its intervention in the currency exchange markets, selling dollars and purchasing won in an attempt to keep the exchange rate above won 1,000 = $1. The main effect of this action, however, was to rapidly deplete South Korea's foreign exchange reserves. These stood at $30 billion on November 1, but fell to only $15 billion two weeks later. With its foreign exchange reserves almost exhausted, the South Korean central bank gave up its defense of the won November 17. Immediately, the price of won in dollars plunged to around won 1,500 = $1, effectively increasing by 60 to 70 percent the amount of won heavily indebted Korean companies had to pay to meet scheduled payments on their dollar-denominated debt. These losses, due to adverse changes in foreign exchange rates, depressed the profits of many firms. South Korean firms suffered foreign exchange losses of more than $15 billion in 1997.[1]

Case Discussion Questions

1. What role did the Korean government play in creating the 1997 crisis?
2. What role did Korean enterprises play in creating the 1997 crisis?
3. Why was the Korean central bank unable to stop the decline in the value of the won?
4. In late 1997, the IMF stepped in with a rescues package that included $55 billion in emergency loans to support the currency. These loans had the effect of stabilizing the won and over the next few years South Korean enjoyed a strong recovery. If the IMF had not stepped in, what might have occurred?

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The Russian Ruble Crisis and its Aftermath

PRELUDE

In the early 1990s, following the collapse of communism and the dissolution of the Soviet Union, the Russian government implemented an economic reform program designed to transform the country's crumbling centrally planned economy into a dynamic market economy. A central element of this plan was an end to price controls on January 1, 1992. Once controls were removed, however, prices surged. Inflation was soon running at a monthly rate of about 30 percent. For the whole of 1992, the inflation rate in Russia was 3,000 percent. The annual rate for 1993 was approximately 900 percent.

Several factors contributed to the spike in Russia's inflation rate. Prices had been held at artificially low levels by state planners during the Communist era. At the same time there was a shortage of many basic goods, so with nothing to spend their money on, many Russians simply hoarded rubles. After the liberalization of price controls, the country was suddenly awash in rubles chasing a still limited supply of goods. The result was to rapidly bid up prices. The inflationary fires that followed price liberalization were stoked by the Russian government itself. Unwilling to face the social consequences of the massive unemployment that would follow if many state-owned enterprises quickly were privatized, the government continued to subsidize the operations of many money-losing establishments. The result was a surge in the government's budget deficit. In the first quarter of 1992, the budget deficit amounted to 1.5 percent of the country's GDP. By the end of 1992, it had risen to 17 percent. Unable or unwilling to finance this deficit by raising taxes, the government found another solution—it printed money, which added fuel to the inflation fire.

With inflation rising, the ruble tumbled in value against the dollar and other major currencies. In January 1992 the exchange rate stood at $1 = R125. By the end of 1992 it was $1 = R480 and by late 1993, it was $1 = R1,500. As 1994 progressed, it became increasingly evident that due to vigorous political opposition, the Russian government would not be able to bring down its budget deficit as quickly as had been thought. By September the monthly inflation rate was accelerating. October started badly, with the ruble sliding more than 10 percent in value against the U.S. dollar in the first 10 days of the month. On October 11, the ruble plunged 21.5 percent against the dollar, reaching a value of $1 = R3,926 by the time the foreign exchange market closed!

Despite the announcement of a tough budget plan that placed tight controls on the money supply, the ruble continued to slide and by April 1995 the exchange rate stood at $1 = R5,120. However, by mid-1995 inflation was again on the way down. In June 1995 the *monthly* inflation rate was at a yearly low of 6.7 percent. Also, the ruble had recovered to stand at $1 = R4,559 by July 6. On that day the Russian government announced it would intervene in the currency market to keep the ruble in a trading range of R4,3000 to R4,900 against the dollar. The Russian government believed that it was essential to maintain a relatively stable currency. Government officials announced that the central bank would be able to draw on $10 billion in foreign exchange reserves to defend the ruble against any speculative selling in Russia's relatively small foreign exchange market.

In the world of international finance, $10 billion is small change and it wasn't long before Russia found that its foreign exchange reserves were being depleted. It was at this point that the Russian government requested

IMF loans. In February 1996, the IMF obliged with its second-largest rescue effort ever, a loan of $10 billion. In return for the loan, Russia agreed to limit the growth in its money supply, reduce public-sector debt, increase government tax revenues, and peg the ruble to the dollar. Russia also rebased the value of the ruble, making one ruble equivalent to 1,000 old rubles.

Initially the package seemed to have the desired effect. Inflation declined from nearly 50 percent in 1996 to about 15 percent in 1997; the exchange rate stayed within its predetermined band of 4.3 to 4.8 rubles per dollar; and the balance-of-payments situation remained broadly favorable. In 1997, the Russian economy grew for the first time since the breakup of the former Soviet Union, if only by a modest half of 1 percent of GDP. However, the public-sector debt situation did not improve. The Russian government continued to spend more than it agreed to under IMF targets, while government tax revenues were much lower than projected. Low tax revenues were in part due to falling oil prices (the government collected tax on oil sales), in part due to the difficulties of collecting tax in an economy where so much economic activity was in the "underground economy," and partly due to a complex tax system that was peppered with loopholes. In 1997, Russian federal government spending amounted to 18.3 percent of GDP, while revenues were only 10.8 percent of GDP, implying a deficit of 7.5 percent of GDP, which was financed by an expansion in public debt.

CRISIS

Dismayed by the failure of Russia to meet its targets, the IMF responded by suspending its scheduled payment to Russia in early 1998, pending reform of Russia's complex tax system and a sustained attempt by the Russian government to cut public spending. This put further pressure on the Russian ruble, forcing the Russian central bank to raise interest rates on overnight loans to 150 percent. In June 1998, the U.S. government indicated it would support a new IMF bailout. The IMF was more circumspect, insisting instead that the Russian government push through a package of corporate tax increases and public spending cuts to balance the budget. The Russian government indicated it would do so, and the IMF released a tranche of $640 million that had been suspended. The IMF followed this with an additional $11.2 billion loan designed to preserve the ruble's stability.

Almost as soon as the funding was announced, however, it began to unravel. The IMF loan required the Russian government to take concrete steps to raise personal tax rates, improve tax collections, and cut government spending. A bill containing the required legislative changes was sent to the Russian parliament, where it was emasculated by antigovernment forces. The IMF responded by withholding $800 million of its first $5.6 billion tranche, undermining the credibility of its own program. The Russian stock market plummeted on the news, closing down 6.5 percent. Selling of rubles accelerated. The central bank began hemorrhaging foreign exchange reserves as it tried to maintain the value of the ruble. Foreign exchange reserves fell by $1.4 billion in the first week of August alone, to $17 billion, while interest rates surged again.

Against this background, on the weekend of August 15–16, top Russian officials huddled to develop a response to the most recent crisis. Their options were limited. The patience of the IMF had been exhausted. Foreign currency reserves were being rapidly depleted. Social tensions in the country were running high. The government faced upcoming redemptions on $18 billion of domestic bonds, with no idea of where the money would come from.

On Monday, August 17, Prime Minister Sergei Kiriyenko announced the results of the weekend's conclave. He said Russia would restructure the domestic debt market, unilaterally transforming short-term debt into long-term debt. In other words, the government had decided to default on its debt commitments. The government also announced a 90-day moratorium on the repayment of private foreign debt and stated it would allow the ruble to decline by 34 percent against the U.S. dollar. In short, Russia had turned its back on the IMF plan. The effect was immediate. Overnight, shops marked up the price of goods by 20 percent. As the ruble plummeted, currency exchange points were only prepared to sell dollars at a rate of 9 rubles per dollar, rather than the new official exchange rate of 6.43 rubles to the dollar. As for Russian government debt, it lost 85 percent of its value in a matter of hours, leaving foreign and Russian holders of debt alike suddenly gaping at a huge black hole in their financial assets.

AFTERMATH

In the aftermath of Russia's default on government debt, the IMF effectively turned its back on the Russian government, leaving the country to fix its own financial mess. With no more IMF loans in the offing, the government had to find some other way to manage its large public-sector deficit. The government took a two-pronged approach; first, it slashed government spending, and second, it reformed the tax system. With regard to the tax system, the government of Vladimir Putin ignored the advice of the IMF, which wanted Russia to raise tax rates and focus on tougher enforcement. Instead, the government replaced Russia's complex income tax code, which had a top marginal rate of

30 percent, with a 13 percent flat tax. Corporate tax rates were also slashed from 35 percent to 24 percent, and the tax code simplified, closing many loopholes. Paradoxically, the cut in tax rates led to a surge in government revenues as individuals and corporations decided it was easier to pay taxes than go to the trouble of avoiding them, which they had long done.

In addition to these government actions, a sharp rise in commodity prices, and particularly world oil prices, helped the Russian economy enormously. Russia is now the world's largest oil exporter, ahead of even Saudi Arabia. In addition, it exports significant amounts of natural gas, metals, and timber, all of which have seen sharp price increases since 1998. The country now runs a large current account surplus with the rest of the world (in 2004 it hit $46 billion).

As a result of these changes, the Russian economy grew at an average annual rate of 6.5 percent between 1998 and 2004. Foreign debt declined from 90 percent of GDP in 1998 to about 28 percent in 2004, while foreign reserves increased tenfold to $120 billion. The government has been running a budget surplus since 1999. In 2004 it took in some $13.1 billion more than it spent. Moreover, in January 2005 the Russian government repaid its entire obligations to the IMF ahead of schedule.

Despite these positive developments, the Russian economy still has numerous structural weaknesses. The country is now very dependent on commodity prices, and if they should fall, the economy will suffer a sharp pullback. The banking system remains weak, the manufacturing infrastructure is poor, the country is still rife with corruption, there is widespread mistrust in the institutions of government, and foreign investment is relatively low.[1]

Case Discussion Questions

1. What were the causes of the surge in inflation in Russia during the early 1990s? Could this have been avoided? How?
2. What does the decline in the value of the ruble against the dollar between 1992 and 1998 teach you about the relationship between inflation rates and currency values?
3. During the mid-1990s, the IMF wanted Russia to raise tax rates, close loopholes in the tax system, and cut public spending. Russia was unable to do this. Why?
4. In the early 2000s Russia cut tax rates for individuals and corporations, and government tax revenues surged. Why? Does this result suggest that the IMF policy prescriptions were wrong?

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part five The Strategy and Structure of International Business

13 The Strategy of International Business

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Explain the concept of strategy.
- **LO2** Recognize how firms can profit by expanding globally.
- **LO3** Understand how pressures for cost reductions and pressures for local responsiveness influence strategic choice.
- **LO4** Identify the different strategies for competing globally and their pros and cons.

Avon Products

For six years after Andrea Jung became CEO in 1999 of Avon Products, the beauty products company famous for its direct-sales model, revenues grew in excess of 10 percent a year. Profits tripled, making Jung a Wall Street favorite. Then in 2005, the success story started to turn ugly. Avon, which derives as much as 70 percent of its revenues from international markets, mostly in developing nations, suddenly began losing sales across the globe. A ban on direct sales had hurt its business in China (the Chinese government had accused companies that used a direct-sales model of engaging in pyramid schemes and of creating "cults"). To compound matters, economic weakness in Eastern Europe, Russia, and Mexico, all drivers of Avon's success, stalled growth there. The dramatic turn of events took investors by surprise. In May 2005 Jung had told investors that Avon would exceed Wall Street's targets for the year. By September she was rapidly backpedaling and the stock fell 45 percent.

With her job on the line, Jung began to reevaluate Avon's global strategy. Until this point, the company had expanded primarily by replicating its U.S. strategy and organization in other countries. When it entered a nation, it gave country managers considerable autonomy. All used the Avon brand name and adopted the direct-sales model that has been the company's hallmark. The result was an army of 5 million Avon representatives around the world, all independent contractors, who sold the company's skin care and makeup products. However, many country managers also set up their own local manufacturing operations and supply chains, were responsible for local marketing, and developed their own new products. In Jung's words, "they were the king or queen of every decision." The result was a lack of consistency in marketing strategy from nation to nation, extensive duplication of manufacturing operations and supply chains, and a profusion of new products, many of which were not profitable. In Mexico, for example, the roster of products for sale had ballooned to 13,000. The company had 15 layers of management, making accountability and communication problematic. There was also a distinct lack of data-driven analysis of new-product opportunities, with country managers often making decisions based on their intuition or gut feeling.



Jung's turnaround strategy involved several elements. To help transform Avon, she hired seasoned managers from well-known global consumer products companies such as Procter & Gamble and Unilever. She flattened the organization to improve communication, performance visibility, and accountability, reducing the number of management layers to just eight and laying off 30 percent of managers. Manufacturing was consolidated in a number of regional centers, and supply chains were rationalized, eliminating duplication and reducing costs by more than $1 billion a year. Rigorous return on investment criteria were introduced to evaluate product profitability. As a consequence, 25 percent of Avon's products were discontinued. New-product decisions were centralized at Avon's headquarters. Jung also invested in centralized product development. The goal was to develop and introduce blockbuster new products that could be positioned as global brands. And Jung pushed the company to emphasize its value proposition in every national market, which could be characterized as high quality at a low price.

By 2007 this strategy was starting to yield dividends. The company's performance improved and growth resumed. It didn't hurt that Jung, a Chinese-American who speaks Mandarin, was instrumental in persuading Chinese authorities to rescind the ban on direct sales, allowing Avon to recruit 400,000 new representatives in China. Then in 2008 and 2009 the global financial crisis hit. Jung's reaction: This was an opportunity for Avon to expand its business. In 2009, Avon ran ads around the world aimed at recruiting sales representatives. In the ads, female sales representatives talked about working for Avon. "I can't get laid off, I can't get fired," is what one said. Phones started to ring of the hook, and Avon was quickly able to expand its global sales force. She also instituted an aggressive pricing strategy, while packaging was redesigned for a more elegant look at no additional cost. The idea was to emphasize the "value for money" the Avon products represented. Media stars were used in ads to help market the company's products, and Avon pushed its representatives to use online social networking sites as a medium for representatives to market themselves. The result: In the difficult years of 2008 and 2009, Avon gained global market share and its financial performance improved.[1]

Introduction

The primary concern thus far in this book has been with aspects of the larger environment in which international businesses compete. As described in the preceding chapters, this environment has included the different political, economic, and cultural institutions found in nations, the international trade and investment framework, and the international monetary system. Now our focus shifts from the environment to the firm itself and, in particular, to the actions managers can take to compete more effectively as an international business. This chapter looks at how firms can increase their profitability by expanding their operations in foreign markets. We discuss the different strategies that firms pursue when competing internationally, consider the pros and cons of these strategies, and study the various factors that affect a firm's choice of strategy.

Avon Products, profiled in the opening case, gives a preview of some issues explored in this chapter. Like many other companies, Avon moved into other countries because it saw huge growth opportunities there. It thought it could create value by transferring the Avon brand, products, and direct-sales model, and giving country managers considerable autonomy to develop the local market. This worked for a long time, but by 2005 the company was running into significant headwinds. Avon's costs were too high, a result of extensive manufacturing duplication across national markets. It had too many products, many of which were not profitable, and the marketing message and branding across nations was inconsistent. In response, CEO Andrea Jung changed the strategy of the company. The autonomy of local country managers was reduced. She consolidated manufacturing and reduced the product line by 25 percent, while emphasizing global brands and a global marketing strategy. This change in strategy helped Avon to take over $1 billion out of its cost structure while fueling an expansion in sales. As we shall see later in this chapter, many other companies have made a similar shift in the past two decades, moving from what can be characterized as a *localization strategy*, where local country managers have considerable autonomy over manufacturing and marketing, to a *global strategy*, where the corporate center exercises more control over manufacturing, marketing, and product development decisions. The tendency to make such a shift in many international businesses is a response to the globalization of markets, a phenomenon first discussed in Chapter 1. We shall discuss this process later in the chapter. To begin, however, we need to define exactly what we mean by strategy.

LO1

Strategy and the Firm

Before we discuss the strategies that managers in the multinational enterprise can pursue, we need to review some basic principles of strategy. A firm's **strategy** can be defined as the actions that managers take to attain the goals of the firm. For most firms, the preeminent goal is to maximize the value of the firm for its owners, its shareholders (subject to the very important constraint that this is done in a legal, ethical, and socially responsible manner—see Chapter 5 for details). To maximize the value of a firm, managers must pursue strategies that increase the *profitability* of the enterprise and its rate of *profit growth* over time (see Figure 13.1). **Profitability** can be measured in a number of ways, but for consistency, we shall define it as the rate of return that the firm makes on its invested capital (ROIC), which is calculated by dividing the net profits of the firm by total invested capital.[2] **Profit growth** is measured by the percentage increase in net profits over time. In general, higher profitability and a higher rate of profit growth will increase the value of an enterprise and thus the returns garnered by its owners, the shareholders.[3]

Managers can increase the profitability of the firm by pursuing strategies that lower costs or by pursuing strategies that add value to the firm's products, which enables the firm to raise prices. Managers can increase the rate at which the firm's profits grow over time by pursuing strategies to sell more products in existing markets or by pursuing strategies to enter new markets. As we shall see, expanding internationally can help managers boost the firm's profitability *and* increase the rate of profit growth over time.

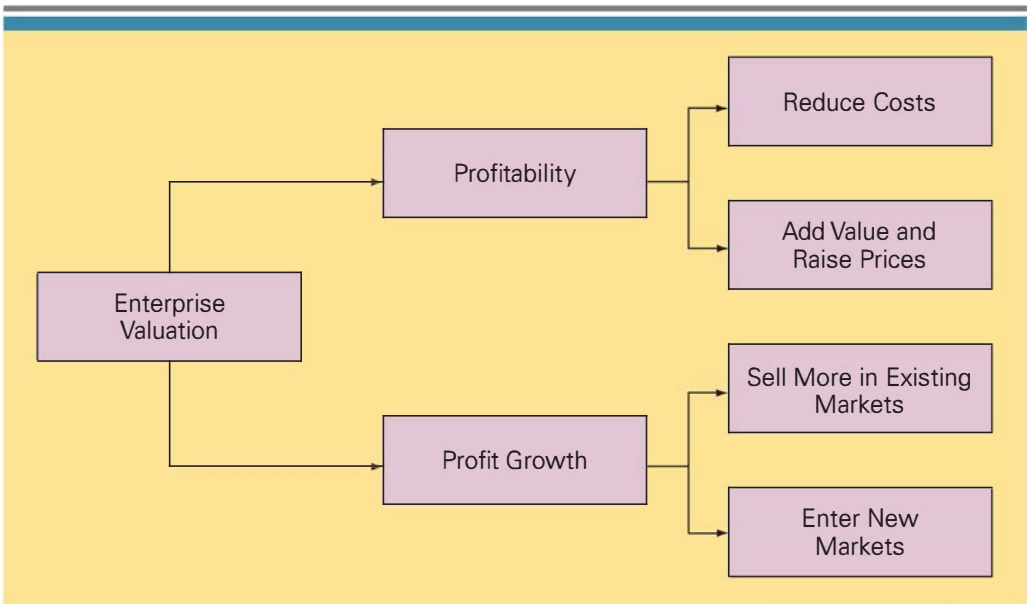


FIGURE 13.1
Determinants of Enterprise Value

VALUE CREATION

The way to increase the profitability of a firm is to create more value. The amount of value a firm creates is measured by the difference between its costs of production and the value that consumers perceive in its products. In general, the more value customers place on a firm's products, the higher the price the firm can charge for those products. However, the price a firm charges for a good or service is typically less than the value placed on that good or service by the customer. This is because the customer captures some of that value in the form of what economists call a consumer surplus.[4] The customer is able to do this because the firm is competing with other firms for the customer's business, so the firm must charge a lower price than it could were it a monopoly supplier. Also, it is normally impossible to segment the market to such a degree that the firm can charge each customer a price that reflects that individual's assessment of the value of a product, which economists refer to as a customer's reservation price. For these reasons, the price that gets charged tends to be less than the value placed on the product by many customers.

Figure 13.2 illustrates these concepts. The value of a product to an *average* consumer is V; the average price that the firm can charge a consumer for that product given competitive pressures and its ability to segment the market is P; and the average unit cost of producing that product is C (C comprises all relevant costs, including the firm's cost of capital). The firm's profit per unit sold (π) is equal to P − C, while the consumer surplus per unit is equal to V − P (another way of thinking of the consumer surplus is as "value

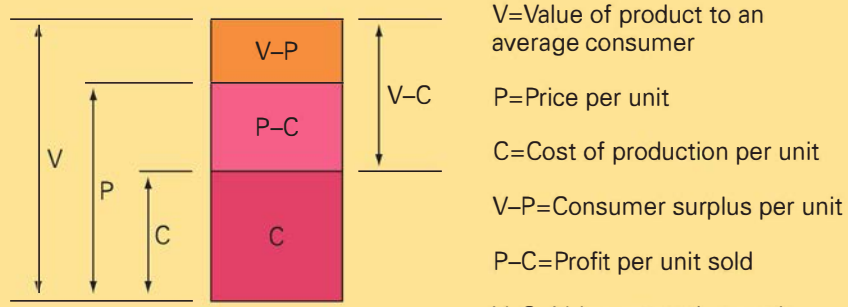


FIGURE 13.2
Value Creation

for the money"; the greater the consumer surplus, the greater the value for the money the consumer gets). The firm makes a profit so long as P is greater than C, and its profit will be greater the lower C is *relative* to P. The difference between V and P is in part determined by the intensity of competitive pressure in the marketplace; the lower the intensity of competitive pressure, the higher the price charged relative to V.[5] In general, the higher the firm's profit per unit sold is, the greater its profitability will be, all else being equal.

The firm's **value creation** is measured by the difference between V and C (V − C); a company creates value by converting inputs that cost C into a product on which consumers place a value of V. A company can create more value (V − C) either by lowering production costs, C, or by making the product more attractive through superior design, styling, functionality, features, reliability, after-sales service, and the like, so that consumers place a greater value on it (V increases) and, consequently, are willing to pay a higher price (P increases). This discussion suggests that *a firm has high profits when it creates more value for its customers and does so at a lower cost*. We refer to a strategy that focuses primarily on lowering production costs as a *low-cost strategy*. We refer to a strategy that focuses primarily on increasing the attractiveness of a product as a *differentiation strategy*.[6]

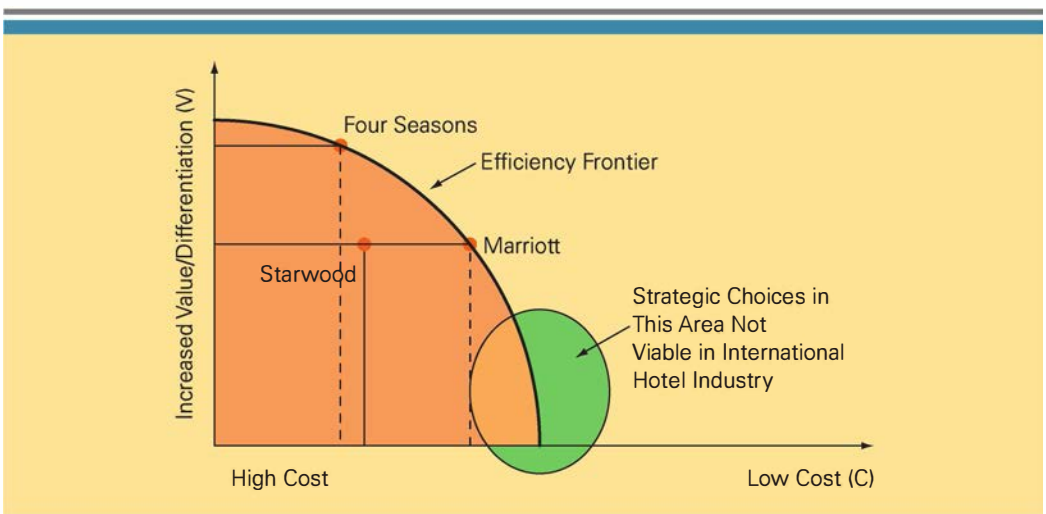
Michael Porter has argued that *low cost* and *differentiation* are two basic strategies for creating value and attaining a competitive advantage in an industry.[7] According to Porter, superior profitability goes to those firms that can create superior value, and the way to create superior value is to drive down the cost structure of the business and/or differentiate the product in some way so that consumers value it more and are prepared to pay a premium price. Superior value creation relative to rivals does not necessarily require a firm to have the lowest cost structure in an industry, or to create the most valuable product in the eyes of consumers. However, it does require that the gap between value (V) and cost of production (C) be greater than the gap attained by competitors.

STRATEGIC POSITIONING

Porter notes that it is important for a firm to be explicit about its choice of strategic emphasis with regard to value creation (differentiation) and low cost, and to configure its internal operations to support that strategic emphasis.[8] Figure 13.3 illustrates his point. The convex curve in Figure 13.3 is what economists refer to as an efficiency frontier. The efficiency frontier shows all of the different positions that a firm can adopt with regard to adding value to the product (V) and low cost (C) assuming that its internal operations are configured efficiently to support a particular position (note that the horizontal axis in Figure 13.3 is reverse scaled—moving along the axis to the right implies lower costs). The efficiency frontier has a convex shape because of diminishing returns. Diminishing returns imply that when a firm already has significant value built into its product offering, increasing value by a relatively small amount requires significant

FIGURE 13.3

Strategic Choice in the International Hotel Industry



additional costs. The converse also holds, when a firm already has a low-cost structure, it has to give up a lot of value in its product offering to get additional cost reductions.

Figure 13.3 plots three hotel firms with a global presence that cater to international travelers, Four Seasons, Marriott International, and Starwood (Starwood owns the Sheraton and Westin chains). Four Seasons positions itself as a luxury chain and emphasizes the value of its product offering, which drives up its costs of operations. Marriott and Starwood are positioned more in the middle of the market. Both emphasize sufficient value to attract international business travelers, but are not luxury chains like Four Seasons. In Figure 13.3, Four Seasons and Marriott are shown to be on the efficiency frontier, indicating that their internal operations are well configured to their strategy and run efficiently. Starwood is inside the frontier, indicating that its operations are not running as efficiently as they might be, and that its costs are too high. This implies that Starwood is less profitable than Four Seasons and Marriott, and that its managers must take steps to improve the company's performance.

Porter emphasizes that it is very important for management to decide where the company wants to be positioned with regard to value (V) and cost (C), to configure operations accordingly, and to manage them efficiently to make sure the firm is operating on the efficiency frontier. However, not all positions on the efficiency frontier are viable. In the international hotel industry, for example, there might not be enough demand to support a chain that emphasizes very low cost and strips all the value out of its product offering (see Figure 13.3). International travelers are relatively affluent and expect a degree of comfort (value) when they travel away from home.

A central tenet of the basic strategy paradigm is that to maximize its profitability, a firm must do three things: (*a*) pick a position on the efficiency frontier that is viable in the sense that there is enough demand to support that choice; (*b*) configure its internal operations, such as manufacturing, marketing, logistics, information systems, human resources, and so on, so that they support that position; and (*c*) make sure that the firm has the right organization structure in place to execute its strategy. *The strategy, operations, and organization of the firm must all be consistent with each other if it is to attain a competitive advantage and garner superior profitability*. By **operations** we mean the different value creation activities a firm undertakes, which we shall review next.

OPERATIONS: THE FIRM AS A VALUE CHAIN

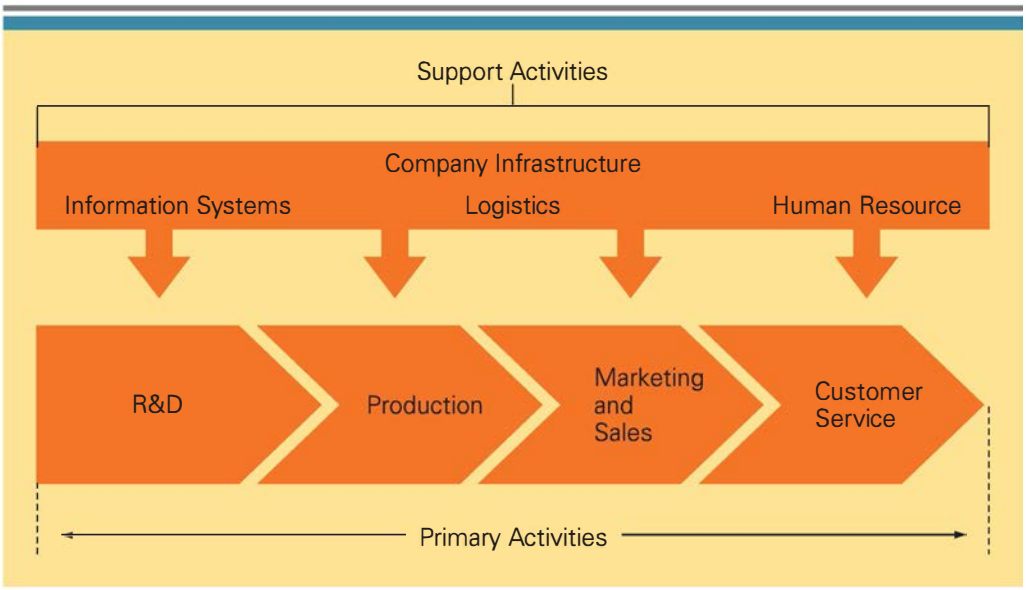
The operations of a firm can be thought of as a value chain composed of a series of distinct value creation activities, including production, marketing and sales, materials management, R&D, human resources, information systems, and the firm infrastructure. We can categorize these value creation activities, or operations, as primary activities and support activities (see Figure 13.4).[9] As noted above, if a firm is to implement its strategy efficiently, and position itself on the efficiency frontier shown in Figure 13.3, it must manage these activities effectively and in a manner that is consistent with its strategy.

Primary Activities

Primary activities have to do with the design, creation, and delivery of the product; its marketing; and its support and after-sale service. Following normal practice, in the value chain illustrated in Figure 13.4, the primary activities are divided into four functions: research and development, production, marketing and sales, and customer service.

Research and development (R&D) is concerned with the design of products and production processes. Although we think of R&D as being associated with the design of physical products and production processes in manufacturing enterprises, many service companies also undertake R&D. For example, banks compete with each other by developing new financial products and new ways of delivering those products to customers. Online banking and smart debit cards are two examples of product development in the banking industry. Earlier examples of innovation in the banking industry included automated teller machines, credit cards, and debit cards. Through

FIGURE 13.4
The Value Chain



superior product design, R&D can increase the functionality of products, which makes them more attractive to consumers (raising V). Alternatively, R&D may result in more efficient production processes, thereby cutting production costs (lowering C). Either way, the R&D function can create value.

Production is concerned with the creation of a good or service. For physical products, when we talk about production we generally mean manufacturing. Thus, we can talk about the production of an automobile. For services such as banking or health care, "production" typically occurs when the service is delivered to the customer (for example, when a bank originates a loan for a customer it is engaged in "production" of the loan). For a retailer such as Walmart, "production" is concerned with selecting the merchandise, stocking the store, and ringing up the sale at the cash register. For MTV, production is concerned with the creation, programming, and broadcasting of content, such as music videos and thematic shows. The production activity of a firm creates value by performing its activities efficiently so lower costs result (lower C) and/or by performing them in such a way that a higher-quality product is produced (which results in higher V).

The marketing and sales functions of a firm can help to create value in several ways. Through brand positioning and advertising, the marketing function can increase the value (V) that consumers perceive to be contained in a firm's product. If these create a favorable impression of the firm's product in the minds of consumers, they increase the price that can be charged for the firm's product. For example, Ford produced a high-value version of its Ford Expedition SUV. Sold as the Lincoln Navigator and priced around $10,000 higher, the Navigator has the same body, engine, chassis, and design as the Expedition, but through skilled advertising and marketing, supported by some fairly minor features changes (e.g., more accessories and the addition of a Lincoln-style engine grille and nameplate), Ford has fostered the perception that the Navigator is a "luxury SUV." This marketing strategy has increased the perceived value (V) of the Navigator relative to the Expedition and enables Ford to charge a higher price for the car (P).

Marketing and sales can also create value by discovering consumer needs and communicating them back to the R&D function of the company, which can then design products that better match those needs. For example, the allocation of research budgets at Pfizer, the world's largest pharmaceutical company, is determined by the marketing function's assessment of the potential market size associated with solving unmet medical needs. Thus, Pfizer is currently directing significant monies to R&D efforts aimed at finding treatments for Alzheimer's disease, principally because marketing has identified the treatment of Alzheimer's as a major unmet medical need in nations around the world where the population is aging.





Perception is everything! Even though the Ford Expedition (left) and the Lincoln Navigator (right) share many of the same attributes, such as the body and engine, customers are willing to pay about $10,000 more for the Navigator's little extras.

The role of the enterprise's service activity is to provide after-sale service and support. This function can create a perception of superior value (V) in the minds of consumers by solving customer problems and supporting customers after they have purchased the product. Caterpillar, the U.S.-based manufacturer of heavy earthmoving equipment, can get spare parts to any point in the world within 24 hours, thereby minimizing the amount of downtime its customers have to suffer if their Caterpillar equipment malfunctions. This is an extremely valuable capability in an industry where downtime is very expensive. It has helped to increase the value that customers associate with Caterpillar products and thus the price that Caterpillar can charge.

Support Activities

The support activities of the value chain provide inputs that allow the primary activities to occur (see Figure 13.4). In terms of attaining a competitive advantage, support activities can be as important as, if not more important than, the "primary" activities of the firm. Consider information systems; these systems refer to the electronic systems for managing inventory, tracking sales, pricing products, selling products, dealing with customer service inquiries, and so on. Information systems, when coupled with the communications features of the Internet, can alter the efficiency and effectiveness with which a firm manages its other value creation activities. Dell, for example, has used its information systems to attain a competitive advantage over rivals. When customers place an order for a Dell product over the firm's website, that information is immediately transmitted, via the Internet, to suppliers, who then configure their production schedules to produce and ship that product so that it arrives at the right assembly plant at the right time. These systems have reduced the amount of inventory that Dell holds at its factories to under two days, which is a major source of cost savings.

The logistics function controls the transmission of physical materials through the value chain, from procurement through production and into distribution. The efficiency with which this is carried out can significantly reduce cost (lower C), thereby creating more value. The combination of logistics systems and information systems is a particularly potent source of cost savings in many enterprises, such as Dell, where information systems tell Dell on a real-time basis where in its global logistics network parts are, when they will arrive at an assembly plant, ands thus how production should be scheduled.

The human resource function can help create more value in a number of ways. It ensures that the company has the right mix of skilled people to perform its value creation activities effectively. The human resource function also ensures that people are adequately trained, motivated, and compensated to perform their value creation tasks. In a multinational enterprise, one of the things human resources can do to boost the competitive position of the firm is to take advantage of its transnational reach to identify, recruit, and develop a cadre of skilled managers, regardless of their nationality, who can be groomed to take on senior management positions. They can find the very best,

wherever they are in the world. Indeed, the senior management ranks of many multinationals are becoming increasingly diverse, as managers from a variety of national backgrounds have ascended to senior leadership positions. Japan's Sony, for example, is now headed not by a Japanese national, but by Howard Stringer, a Welshman.

The final support activity is the company infrastructure, or the context within which all the other value creation activities occur. The infrastructure includes the organizational structure, control systems, and culture of the firm. Because top management can exert considerable influence in shaping these aspects of a firm, top management should also be viewed as part of the firm's infrastructure. Through strong leadership, top management can consciously shape the infrastructure of a firm and through that the performance of all its value creation activities.

LO2

Global Expansion, Profitability, and Profit Growth

Expanding globally allows firms to increase their profitability and rate of profit growth in ways not available to purely domestic enterprises.[10] Firms that operate internationally are able to:

1. Expand the market for their domestic product offerings by selling those products in international markets.
2. Realize location economies by dispersing individual value creation activities to those locations around the globe where they can be performed most efficiently and effectively.
3. Realize greater cost economies from experience effects by serving an expanded global market from a central location, thereby reducing the costs of value creation.
4. Earn a greater return by leveraging any valuable skills developed in foreign operations and transferring them to other entities within the firm's global network of operations.

As we will see, however, a firm's ability to increase its profitability and profit growth by pursuing these strategies is constrained by the need to customize its product offering, marketing strategy, and business strategy to differing national conditions, that is, by the imperative of localization.

EXPANDING THE MARKET: LEVERAGING PRODUCTS AND COMPETENCIES

A company can increase its growth rate by taking goods or services developed at home and selling them internationally. Almost all multinationals started out doing just this. For example, Procter & Gamble developed most of its best-selling products such as Pampers disposable diapers and Ivory soap in the United States, and subsequently then sold them around the world. Likewise, although Microsoft developed its software in the United States, from its earliest days the company has always focused on selling that software in international markets. Automobile companies such as Volkswagen and Toyota also grew by developing products at home and then selling them in international markets. The returns from such a strategy are likely to be greater if indigenous competitors in the nations a company enters lack comparable products. Thus, Toyota increased its profits by entering the large automobile markets of North America and Europe, offering products that were different from those offered by local rivals (Ford and GM) by their superior quality and reliability.

The success of many multinational companies that expand in this manner is based not just upon the goods or services that they sell in foreign nations, but also upon the core competencies that underlie the development, production, and marketing of those

goods or services. The term **core competence** refers to skills within the firm that competitors cannot easily match or imitate.[11] These skills may exist in any of the firm's value creation activities—production, marketing, R&D, human resources, logistics, general management, and so on. Such skills are typically expressed in product offerings that other firms find difficult to match or imitate. Core competencies are the bedrock of a firm's competitive advantage. They enable a firm to reduce the costs of value creation and/or to create perceived value in such a way that premium pricing is possible. For example, Toyota has a core competence in the production of cars. It is able to produce high-quality, well-designed cars at a lower delivered cost than any other firm in the world. The competencies that enable Toyota to do this seem to reside primarily in the firm's production and logistics functions.[12] McDonald's has a core competence in managing fast-food operations (it seems to be one of the most skilled firms in the world in this industry); Procter & Gamble has a core competence in developing and marketing name brand consumer products (it is one of the most skilled firms in the world in this business); Starbucks has a core competence in the management of retail outlets selling high volumes of freshly brewed coffee-based drinks.

Since core competencies are by definition the source of a firm's competitive advantage, the successful global expansion by manufacturing companies such as Toyota and P&G was based not just on leveraging products and selling them in foreign markets, but also on the transfer of core competencies to foreign markets where indigenous competitors lacked them. The same can be said of companies engaged in the service sectors of an economy, such as financial institutions, retailers, restaurant chains, and hotels. Expanding the market for their services often means replicating their business model in foreign nations (albeit with some changes to account for local differences, which we will discuss in more detail shortly). Starbucks, for example, expanded rapidly outside of the United States by taking the basic business model it developed at home and using that as a blueprint for establishing international operations. Similarly, McDonald's is famous for its international expansion strategy, which has taken the company into more than 120 nations that collectively generate over half of the company's revenues.

LOCATION ECONOMIES

Earlier chapters revealed that countries differ along a range of dimensions, including the economic, political, legal, and cultural, and that these differences can either raise or lower the costs of doing business in a country. The theory of international trade also teaches that due to differences in factor costs, certain countries have a comparative advantage in the production of certain products. Japan might excel in the production of automobiles and consumer electronics; the United States in the production of computer software, pharmaceuticals, biotechnology products, and financial services; Switzerland in the production of precision instruments and pharmaceuticals; South Korea in the production of semiconductors; and China in the production of apparel.[13]

For a firm that is trying to survive in a competitive global market, this implies that *trade barriers and transportation costs* permitting, the firm will benefit by basing each value creation activity it performs at that location where economic, political, and cultural conditions, including relative factor costs, are most conducive to the performance of that activity. Thus, if the best designers for a product live in France, a firm should base its design operations in France. If the most productive labor force for assembly operations is in Mexico, assembly operations should be based in Mexico. If the best marketers are in the United States, the marketing strategy should be formulated in the United States. And so on.

Firms that pursue such a strategy can realize what we refer to as **location economies,** which are the economies that arise from performing a value creation activity in the optimal location for that activity, wherever in the world that might be (transportation costs and trade barriers permitting). Locating a value creation activity in the optimal location for that activity can have one of two effects. *It can lower the costs of value creation and help the firm to achieve a low-cost position, and/or it can enable a firm to differentiate its*

product offering from those of competitors. In terms of Figure 13.2, it can lower C and/or increase V (which in general supports higher pricing), both of which boost the profitability of the enterprise.

For an example of how this works in an international business, consider Clear Vision, a manufacturer and distributor of eyewear. Started by David Glassman, the firm now generates annual gross revenues of more than $100 million. Not exactly small, but no corporate giant either, Clear Vision is a multinational firm with production facilities on three continents and customers around the world. Clear Vision began its move toward becoming a multinational when its sales were still less than $20 million. At the time, the U.S. dollar was very strong and this made U.S.-based manufacturing expensive. Low-priced imports were taking an ever-larger share of the U.S. eyewear market, and Clear Vision realized it could not survive unless it also began to import. Initially the firm bought from independent overseas manufacturers, primarily in Hong Kong. However, the firm became dissatisfied with these suppliers' product quality and delivery. As Clear Vision's volume of imports increased, Glassman decided the best way to guarantee quality and delivery was to set up Clear Vision's own manufacturing operation overseas. Accordingly, Clear Vision found a Chinese partner, and together they opened a manufacturing facility in Hong Kong, with Clear Vision being the majority shareholder.

The choice of the Hong Kong location was influenced by its combination of low labor costs, a skilled workforce, and tax breaks given by the Hong Kong government. The firm's objective at this point was to lower production costs by locating value creation activities at an appropriate location. After a few years, however, the increasing industrialization of Hong Kong and a growing labor shortage had pushed up wage rates to the extent that it was no longer a low-cost location. In response, Glassman and his Chinese partner moved part of their manufacturing to a plant in mainland China to take advantage of the lower wage rates there. Again, the goal was to lower production costs. The parts for eyewear frames manufactured at this plant are shipped to the Hong Kong factory for final assembly and then distributed to markets in North and South America. The Hong Kong factory now employs 80 people and the China plant between 300 and 400.

At the same time, Clear Vision was looking for opportunities to invest in foreign eyewear firms with reputations for fashionable design and high quality. Its objective was not to reduce production costs but to launch a line of high-quality differentiated, "designer" eyewear. Clear Vision did not have the design capability in-house to support such a line, but Glassman knew that certain foreign manufacturers did. As a result, Clear Vision invested in factories in Japan, France, and Italy, holding a minority shareholding in each case. These factories now supply eyewear for Clear Vision's Status Eye division, which markets high-priced designer eyewear.[14]

Thus, to deal with a threat from foreign competition, Clear Vision adopted a strategy intended to lower its cost structure (lower C): shifting its production from a high-cost location, the United States, to a low-cost location, first Hong Kong and later China. Then Clear Vision adopted a strategy intended to increase the perceived value of its product (increase V) so it could charge a premium price (P). Reasoning that premium pricing in eyewear depended on superior design, its strategy involved investing capital in French, Italian, and Japanese factories that had reputations for superior design. In sum, Clear Vision's strategies included some actions intended to reduce its costs of creating value and other actions intended to add perceived value to its product through differentiation. The overall goal was to increase the value created by Clear Vision and thus the profitability of the enterprise. To the extent that these strategies were successful, the firm should have attained a higher profit margin and greater profitability than if it had remained a U.S.-based manufacturer of eyewear.

Creating a Global Web

Generalizing from the Clear Vision example, one result of this kind of thinking is the creation of a **global web** of value creation activities, with different stages of the value chain being dispersed to those locations around the globe where perceived value is

maximized or where the costs of value creation are minimized.[15] Consider Lenova's ThinkPad laptop computers (Lenova is the Chinese computer company that purchased IBM's personal computer operations in 2005).[16] This product is designed in the United States by engineers because Lenova believes that the United States is the best location in the world to do the basic design work. The case, keyboard, and hard drive are made in Thailand; the display screen and memory in South Korea; the built-in wireless card in Malaysia; and the microprocessor in the United States. In each case, these components are manufactured and sourced from the optimal location given current factor costs. These components are than shipped to an assembly operation in Mexico, where the product is assembled before being shipped to the United States for final sale. Lenova assembles the ThinkPad in China because managers have calculated that due to low labor costs, the costs of assembly can be minimized there. The marketing and sales strategy for North America is developed by Lenova personnel in the United States, primarily because managers believe that due to their knowledge of the local marketplace, U.S. personnel add more value to the product through their marketing efforts than personnel based elsewhere.

In theory, a firm that realizes location economies by dispersing each of its value creation activities to its optimal location should have a competitive advantage vis-à-vis a firm that bases all of its value creation activities at a single location. It should be able to better differentiate its product offering (thereby raising perceived value, V) and lower its cost structure (C) than its single-location competitor. In a world where competitive pressures are increasing, such a strategy may become an imperative for survival.

Some Caveats

Introducing transportation costs and trade barriers complicates this picture. Due to favorable factor endowments, New Zealand may have a comparative advantage for automobile assembly operations, but high transportation costs would make it an uneconomical location from which to serve global markets. Another caveat concerns the importance of assessing political and economic risks when making location decisions. Even if a country looks very attractive as a production location when measured against all the standard criteria, if its government is unstable or totalitarian, the firm might be advised not to base production there. (Political risk is discussed in Chapter 2.) Similarly, if the government appears to be pursuing inappropriate economic policies that could lead to foreign exchange risk, that might be another reason for not basing production in that location, even if other factors look favorable.

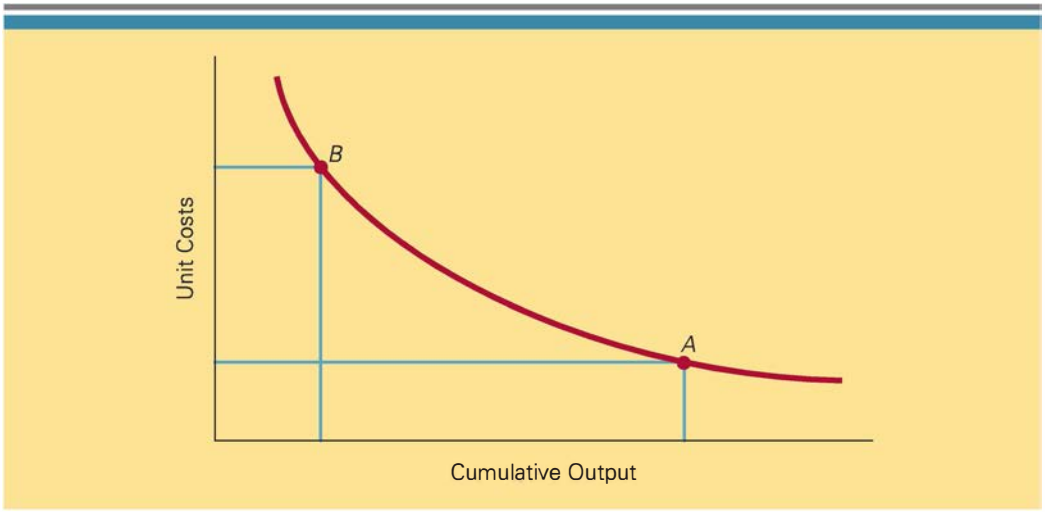
EXPERIENCE EFFECTS

The **experience curve** refers to systematic reductions in production costs that have been observed to occur over the life of a product.[17] A number of studies have observed that a product's production costs decline by some quantity about each time *cumulative* output doubles. The relationship was first observed in the aircraft industry, where each time cumulative output of airframes was doubled, unit costs typically declined to 80 percent of their previous level.[18] Thus, production cost for the fourth airframe would be 80 percent of production cost for the second airframe, the eighth airframe's production costs 80 percent of the fourth's, the sixteenth's 80 percent of the eighth's, and so on. Figure 13.5 illustrates this experience curve relationship between unit production costs and *cumulative* output (the relationship is for *cumulative* output over time, and *not* output in any one period, such as a year). Two things explain this: learning effects and economies of scale.

Learning Effects

Learning effects refer to cost savings that come from learning by doing. Labor, for example, learns by repetition how to carry out a task, such as assembling airframes, most efficiently. Labor productivity increases over time as individuals learn the most efficient ways to perform particular tasks. Equally important, in new production facilities

FIGURE 13.5
The Experience Curve



management typically learns how to manage the new operation more efficiently over time. Hence, production costs decline due to increasing labor productivity and management efficiency, which increases the firm's profitability.

Learning effects tend to be more significant when a technologically complex task is repeated, because there is more that can be learned about the task. Thus, learning effects will be more significant in an assembly process involving 1,000 complex steps than in one of only 100 simple steps. No matter how complex the task, however, learning effects typically disappear after a while. It has been suggested that they are important only during the start-up period of a new process and that they cease after two or three years.[19] Any decline in the experience curve after such a point is due to economies of scale.

Economies of Scale

Economies of scale refer to the reductions in unit cost achieved by producing a large volume of a product. Attaining economies of scale lowers a firm's unit costs and increases its profitability. Economies of scale have a number of sources. One is the ability to spread fixed costs over a large volume.[20] Fixed costs are the costs required to set up a production facility, develop a new product, and the like. They can be substantial. For example, the fixed cost of establishing a new production line to manufacture semiconductor chips now exceeds $1 billion. Similarly, according to one estimate, developing a new drug and bringing it to market costs about $800 million and takes about 12 years.[21] The only way to recoup such high fixed costs may be to sell the product worldwide, which reduces average unit costs by spreading fixed costs over a larger volume. The more rapidly that cumulative sales volume is built up, the more rapidly fixed costs can be amortized over a large production volume, and the more rapidly unit costs will fall.

Second, a firm may not be able to attain an efficient scale of production unless it serves global markets. In the automobile industry, for example, an efficiently scaled factory is one designed to produce about 200,000 units a year. Automobile firms would prefer to produce a single model from each factory since this eliminates the costs associated with switching production from one model to another. If domestic demand for a particular model is only 100,000 units a year, the inability to attain a 200,000-unit output will drive up average unit costs. By serving international markets as well, however, the firm may be able to push production volume up to 200,000 units a year, thereby reaping greater scale economies, lowering unit costs, and boosting profitability. By serving domestic and international markets from its production facilities a firm may be able to utilize those facilities more intensively. For example, if Intel sold microprocessors only in the United States, it might be able to keep its factories open for only one shift,

five days a week. By serving international markets from the same factories, Intel can utilize its productive assets more intensively, which translates into higher capital productivity and greater profitability.

Finally, as global sales increase the size of the enterprise, so its bargaining power with suppliers increases, which may allow it to attain economies of scale in purchasing, bargaining down the cost of key inputs and boosting profitability that way. For example, Walmart has used its enormous sales volume as a lever to bargain down the price it pays suppliers for merchandise sold through its stores.

Strategic Significance

The strategic significance of the experience curve is clear. Moving down the experience curve allows a firm to reduce its cost of creating value (to lower C in Figure 13.2) and increase its profitability. The firm that moves down the experience curve most rapidly will have a cost advantage vis-à-vis its competitors. Firm A in Figure 13.5, because it is farther down the experience curve, has a clear cost advantage over firm B.

Many of the underlying sources of experience-based cost economies are plant based. This is true for most learning effects as well as for the economies of scale derived by spreading the fixed costs of building productive capacity over a large output, attaining an efficient scale of output, and utilizing a plant more intensively. Thus, one key to progressing downward on the experience curve as rapidly as possible is to increase the volume produced by a single plant as rapidly as possible. Because global markets are larger than domestic markets, a firm that serves a global market from a single location is likely to build accumulated volume more quickly than a firm that serves only its home market or that serves multiple markets from multiple production locations. Thus, serving a global market from a single location is consistent with moving down the experience curve and establishing a low-cost position. In addition, to get down the experience curve rapidly, a firm may need to price and market aggressively so demand will expand rapidly. It will also need to build sufficient production capacity for serving a global market. Also, the cost advantages of serving the world market from a single location will be even more significant if that location is the optimal one for performing the particular value creation activity.

Once a firm has established a low-cost position, it can act as a barrier to new competition. Specifically, an established firm that is well down the experience curve, such as firm A in Figure 13.5, can price so that it is still making a profit while new entrants, which are farther up the curve, are suffering losses.

The classic example of the successful pursuit of such a strategy concerns the Japanese consumer electronics company Matsushita. Along with Sony and Philips, Matsushita was in the race to develop a commercially viable videocassette recorder in the 1970s. Although Matsushita initially lagged behind Philips and Sony, it was able to get its VHS format accepted as the world standard and to reap enormous experience curve-based cost economies in the process. This cost advantage subsequently constituted a formidable barrier to new competition. Matsushita's strategy was to build global volume as rapidly as possible. To ensure it could accommodate worldwide demand, the firm increased its production capacity 33-fold from 205,000 units in 1977 to 6.8 million units by 1984. By serving the world market from a single location in Japan, Matsushita realized significant learning effects and economies of scale. These allowed Matsushita to drop its prices 50 percent within five years of selling its first VHS-format VCR. As a result, Matsushita was the world's major VCR producer by 1983, accounting for about 45 percent of world production and enjoying a significant cost advantage over its competitors. The next largest firm, Hitachi, accounted for only 11.1 percent of world production in 1983.[22] Today, firms such as Intel are the masters of this kind of strategy. The costs of building a state-of-the-art facility to manufacture microprocessors are so large (now in excess of $2 billion) that to make this investment pay Intel *must* pursue experience curve effects, serving world markets from a limited number of plants to maximize the cost economies that derive from scale and learning effects.

LEVERAGING SUBSIDIARY SKILLS

Implicit in our earlier discussion of core competencies is the idea that valuable skills are developed first at home and then transferred to foreign operations. However, for more mature multinationals that have already established a network of subsidiary operations in foreign markets, the development of valuable skills can just as well occur in foreign subsidiaries.[23] Skills can be created anywhere within a multinational's global network of operations, wherever people have the opportunity and incentive to try new ways of doing things. The creation of skills that help to lower the costs of production, or to enhance perceived value and support higher product pricing, is not the monopoly of the corporate center.

Leveraging the skills created within subsidiaries and applying them to other operations within the firm's global network may create value. McDonald's increasingly is finding that its foreign franchisees are a source of valuable new ideas. Faced with slow growth in France, its local franchisees have begun to experiment not only with the menu, but also with the layout and theme of restaurants. Gone are the ubiquitous golden arches; gone too are many of the utilitarian chairs and tables and other plastic features of the fast-food giant. Many McDonald's restaurants in France now have hardwood floors, exposed brick walls, and even armchairs. Half of the 930 or so outlets in France have been upgraded to a level that would make them unrecognizable to an American. The menu, too, has been changed to include premier sandwiches, such as chicken on focaccia bread, priced some 30 percent higher than the average hamburger. In France at least, the strategy seems to be working. Following the change, increases in same-store sales rose from 1 percent annually to 3.4 percent. Impressed with the impact, McDonald's executives are considering similar changes at other McDonald's restaurants in markets where same-store sales growth is sluggish, including the United States.[24]

For the managers of the multinational enterprise, this phenomenon creates important new challenges. First, they must have the humility to recognize that valuable skills that lead to competencies can arise anywhere within the firm's global network, not just at the corporate center. Second, they must establish an incentive system that encourages local employees to acquire new skills. This is not as easy as it sounds. Creating new skills involves a degree of risk. Not all new skills add value. For every valuable idea created by a McDonald's subsidiary in a foreign country, there may be several failures. The management of the multinational must install incentives that encourage employees to take the necessary risks. The company must reward people for successes and not sanction them unnecessarily for taking risks that did not pan out. Third, managers must have a process for identifying when valuable new skills have been created in a subsidiary. And finally, they need to act as facilitators, helping to transfer valuable skills within the firm.

SUMMARY

We have seen how firms that expand globally can increase their profitability and profit growth by entering new markets where indigenous competitors lack similar competencies, by lowering costs and adding value to their product offering through the attainment of location economies, by exploiting experience curve effects, and by transferring valuable skills between their global network of subsidiaries. For completeness it should be noted that strategies that increase profitability may also expand a firm's business, and thus enable it to attain a higher rate of profit growth. For example, by simultaneously realizing location economies and experience effects a firm may be able to produce a more highly valued product at a lower unit cost, thereby boosting profitability. The increase in the perceived value of the product may also attract more customers, thereby growing revenues and profits as well. Furthermore, rather than raising prices to reflect the higher perceived value of the product, the firm's managers may elect to hold prices low in order to increase global market share and attain greater scale economies (in other words, they may elect to offer consumers better "value for money"). Such a strategy could increase the firm's rate of profit growth even further, since consumers will be attracted by prices

that are low relative to value. The strategy might also increase profitability if the scale economies that result from market share gains are substantial. In sum, managers need to keep in mind the complex relationship between profitability and profit growth when making strategic decisions about pricing.

Cost Pressures and Pressures for Local Responsiveness

LO3

Firms that compete in the global marketplace typically face two types of competitive pressure that affect their ability to realize location economies and experience effects, to leverage products and transfer competencies and skills within the enterprise. They face *pressures for cost reductions* and *pressures to be locally responsive* (see Figure 13.6).[25] These competitive pressures place conflicting demands on a firm. Responding to pressures for cost reductions requires that a firm try to minimize its unit costs. But responding to pressures to be locally responsive requires that a firm differentiate its product offering and marketing strategy from country to country in an effort to accommodate the diverse demands arising from national differences in consumer tastes and preferences, business practices, distribution channels, competitive conditions, and government policies. Because differentiation across countries can involve significant duplication and a lack of product standardization, it may raise costs.

While some enterprises, such as firm A in Figure 13.6, face high pressures for cost reductions and low pressures for local responsiveness, and others, such as firm B, face low pressures for cost reductions and high pressures for local responsiveness, many companies are in the position of firm C. They face high pressures for *both* cost reductions and local responsiveness. Dealing with these conflicting and contradictory pressures is a difficult strategic challenge, primarily because being locally responsive tends to raise costs.

PRESSURES FOR COST REDUCTIONS

In competitive global markets, international businesses often face pressures for cost reductions. Responding to pressures for cost reduction requires a firm to try to lower the costs of value creation. A manufacturer, for example, might mass-produce a standardized product at the optimal location in the world, wherever that might be, to realize

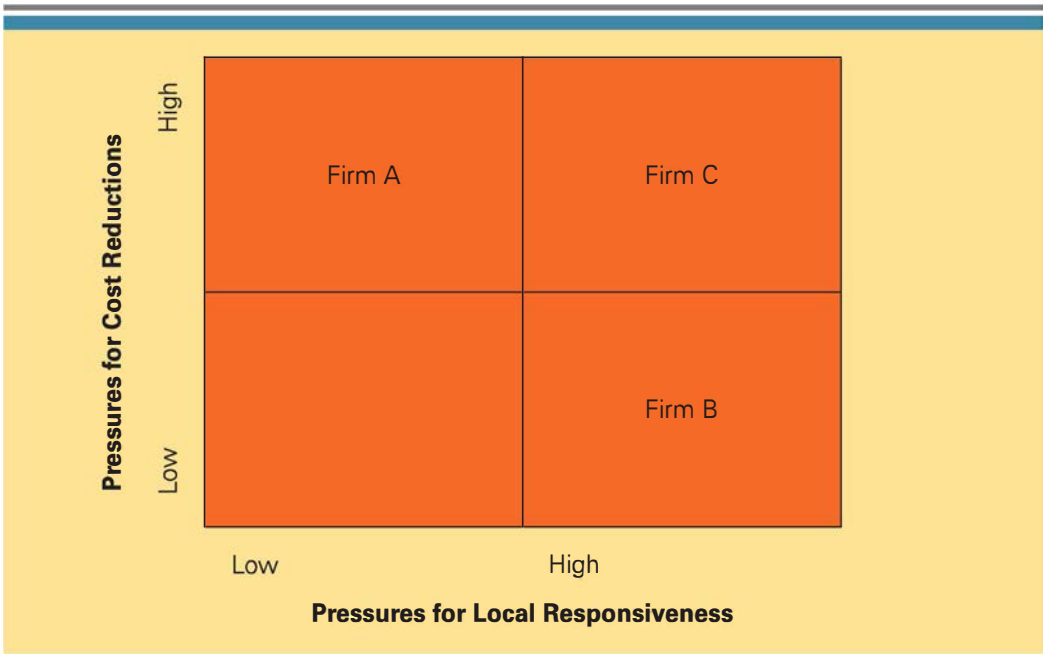


FIGURE 13.6
Pressures for Cost Reductions and Local Responsiveness

economies of scale, learning effects, and location economies. Alternatively, a firm might outsource certain functions to low-cost foreign suppliers in an attempt to reduce costs. Thus, many computer companies have outsourced their telephone-based customer service functions to India, where qualified technicians who speak English can be hired for a lower wage rate than in the United States. In the same manner, a retailer such as Walmart might push its suppliers (manufacturers) to do the same. (The pressure that Walmart has placed on its suppliers to reduce prices has been cited as a major cause of the trend among North American manufacturers to shift production to China.)[26] A service business such as a bank might respond to cost pressures by moving some back-office functions, such as information processing, to developing nations where wage rates are lower.

Pressures for cost reduction can be particularly intense in industries producing commodity-type products where meaningful differentiation on nonprice factors is difficult and price is the main competitive weapon. This tends to be the case for products that serve universal needs. **Universal needs** exist when the tastes and preferences of consumers in different nations are similar if not identical. This is the case for conventional commodity products such as bulk chemicals, petroleum, steel, sugar, and the like. It also tends to be the case for many industrial and consumer products, for example, handheld calculators, semiconductor chips, personal computers, and liquid crystal display screens. Pressures for cost reductions are also intense in industries where major competitors are based in low-cost locations, where there is persistent excess capacity, and where consumers are powerful and face low switching costs. The liberalization of the world trade and investment environment in recent decades, by facilitating greater international competition, has generally increased cost pressures.[27]

PRESSURES FOR LOCAL RESPONSIVENESS

Pressures for local responsiveness arise from national differences in consumer tastes and preferences, infrastructure, accepted business practices, and distribution channels, and from host-government demands. Responding to pressures to be locally responsive requires a firm to differentiate its products and marketing strategy from country to country to accommodate these factors, all of which tends to raise the firm's cost structure.

Differences in Customer Tastes and Preferences

Strong pressures for local responsiveness emerge when customer tastes and preferences differ significantly between countries, as they often do for deeply embedded historic or cultural reasons. In such cases, a multinational's products and marketing message have to be customized to appeal to the tastes and preferences of local customers. This typically creates pressure to delegate production and marketing responsibilities and functions to a firm's overseas subsidiaries.

For example, the automobile industry in the 1980s and early 1990s moved toward the creation of "world cars." The idea was that global companies such as General Motors, Ford, and Toyota would be able to sell the same basic vehicle the world over, sourcing it from centralized production locations. If successful, the strategy would have enabled automobile companies to reap significant gains from global scale economies. However, this strategy frequently ran aground upon the hard rocks of consumer reality. Consumers in different automobile markets seem to have different tastes and preferences, and demand different types of vehicles. North American consumers show a strong demand for pickup trucks. This is particularly true in the South and West where many families have a pickup truck as a second or third car. But in European countries, pickup trucks are seen purely as utility vehicles and are purchased primarily by firms rather than individuals. As a consequence, the product mix and marketing message needs to be tailored to consider the different nature of demand in North America and Europe.

Some commentators have argued that customer demands for local customization are on the decline worldwide.[28] According to this argument, modern communications and

MANAGEMENT FOCUS

Local Responsiveness at MTV Networks

MTV Networks has become a symbol of globalization. Established in 1981, the U.S.-based TV network has been expanding outside of its North American base since 1987 when it opened MTV Europe. Today MTV Networks figures that every second of every day over 2 million people are watching MTV around the world, the majority outside the United States. Despite its international success, MTV's global expansion got off to a weak start. In the 1980s, when the main programming fare was still music videos, it piped a single feed across Europe almost entirely composed of American programming with English-speaking veejays. Naively, the network's U.S. managers thought Europeans would flock to the American programming. But while viewers in Europe shared a common interest in a handful of global superstars, their tastes turned out to be surprisingly local. After losing share to local competitors, who focused more on local tastes, MTV changed it strategy in the 1990s. It broke its service into "feeds" aimed at national or regional markets. While MTV Networks exercises creative control over these different feeds, and while all the channels have the same familiar frenetic look and feel of MTV in the United States, a significant share of the programming and content is now local.

Today an increasing share of programming is local in conception. Although a lot of programming ideas still originate in the United States, with staples such as "The Real World" having equivalents in different countries, an increasing share of programming is local in conception. In Italy, "MTV Kitchen" combines cooking with a music countdown. "Erotica" airs in Brazil and features a panel of youngsters discussing sex. The Indian channel produces 21 homegrown shows hosted by local veejays who speak "Hinglish," a city-bred version of Hindi and English. Many feeds still feature music videos by locally popular performers. This localization push reaped big benefits for MTV, allowing the network to capture viewers back from local imitators.[29]

transport technologies have created the conditions for a convergence of the tastes and preferences of consumers from different nations. The result is the emergence of enormous global markets for standardized consumer products. The worldwide acceptance of McDonald's hamburgers, Coca-Cola, Gap clothes, Nokia cell phones, and Sony PlayStations, all of which are sold globally as standardized products, are often cited as evidence of the increasing homogeneity of the global marketplace.

However, this argument seems somewhat naïve in many consumer goods markets. Significant differences in consumer tastes and preferences still exist across nations and cultures. Managers in international businesses do not yet have the luxury of being able to ignore these differences, and they may not for a long time to come. Even in a modern industry such as the cell phone business, important national differences in consumer usage patterns can be observed. Until the introduction of Apple's iPhone in 2007 Americans tended to think of cell phones primarily as devices for talking, and not as devices that can also send e-mails and browse the web. Consequently, when selling to U.S. consumers, cell phone manufacturers focused more on slim good looks and less on advanced functions and features. This was in direct contrast to Asia and Europe, where text messaging and web browsing functions were much more widely embraced by the early 2000s. A cultural issue seems to be at work here. People in Europe and Asia often have more time to browse the web on their phones because they spend more time commuting on trains, while Americans tend to spend more time in cars, where their hands are occupied.[30] However, it is now clear that key technological innovations in the United States, and particularly the development of the iPhone by Apple, is changing this. For an example of a company that has discovered how important pressures for local responsiveness can still be, read the accompanying Management Focus on MTV Networks.

Differences in Infrastructure and Traditional Practices

Pressures for local responsiveness arise from differences in infrastructure or traditional practices among countries, creating a need to customize products accordingly. Fulfilling this need may require the delegation of manufacturing and production functions to foreign subsidiaries. For example, in North America, consumer electrical systems are based on 110 volts, whereas in some European countries, 240-volt systems are standard. Thus, domestic electrical appliances have to be customized for this difference in infrastructure. Traditional practices also often vary across nations. For example, in Britain, people drive on the left-hand side of the road, creating a demand for right-hand-drive cars, whereas in France (and the rest of Europe), people drive on the right-hand side of the road and therefore want left-hand-drive cars. Obviously, automobiles have to be customized to accommodate this difference in traditional practice.

Although many national differences in infrastructure are rooted in history, some are quite recent. For example, in the wireless telecommunications industry different technical standards exist in different parts of the world. A technical standard known as GSM is common in Europe, and an alternative standard, CDMA, is more common in the United States and parts of Asia. Equipment designed for GSM will not work on a CDMA network, and vice versa. Thus, companies such as Nokia, Motorola, and Ericsson, which manufacture wireless handsets and infrastructure such as switches, need to customize their product offering according to the technical standard prevailing in a given country.

Differences in Distribution Channels

A firm's marketing strategies may have to be responsive to differences in distribution channels among countries, which may necessitate the delegation of marketing functions to national subsidiaries. In the pharmaceutical industry, for example, the British and Japanese distribution systems are radically different from the U.S. system. British and Japanese doctors will not accept or respond favorably to a U.S.-style high-pressure sales force. Thus, pharmaceutical companies have to adopt different marketing practices in Britain and Japan compared with the United States—soft sell versus hard sell. Similarly, Poland, Brazil, and Russia all have similar per capita income on a purchasing power parity basis, but there are big differences in distribution systems across the three countries. In Brazil, supermarkets account for 36 percent of food retailing, in Poland for 18 percent, and in Russia for less than 1 percent.[31] These differences in channels require that companies adapt their own distribution and sales strategy.

Host Government Demands

Economic and political demands imposed by host-country governments may require local responsiveness. For example, pharmaceutical companies are subject to local clinical testing, registration procedures, and pricing restrictions, all of which make it necessary that the manufacturing and marketing of a drug should meet local requirements. Because governments and government agencies control a significant proportion of the health care budget in most countries, they are in a powerful position to demand a high level of local responsiveness.

More generally, threats of protectionism, economic nationalism, and local content rules (which require that a certain percentage of a product should be manufactured locally) dictate that international businesses manufacture locally. For example, consider Bombardier, the Canadian-based manufacturer of railcars, aircraft, jet boats, and snowmobiles. Bombardier has 12 railcar factories across Europe. Critics of the company argue that the resulting duplication of manufacturing facilities leads to high costs and helps explain why Bombardier makes lower profit margins on its railcar operations than on its other business lines. In reply, managers at Bombardier argue that in Europe, informal rules with regard to local content favor people who use local workers. To sell railcars in Germany, they claim, you must manufacture in Germany. The same goes for Belgium, Austria, and France. To try to address its cost structure in Europe, Bombardier

has centralized its engineering and purchasing functions, but it has no plans to centralize manufacturing.[32]

Choosing a Strategy

LO4

Pressures for local responsiveness imply that it may not be possible for a firm to realize the full benefits from economies of scale, learning effects, and location economies. It may not be possible to serve the global marketplace from a single low-cost location, producing a globally standardized product, and marketing it worldwide to attain the cost reductions associated with experience effects. The need to customize the product offering to local conditions may work against the implementation of such a strategy. For example, automobile firms have found that Japanese, American, and European consumers demand different kinds of cars, and this necessitates producing products that are customized for local markets. In response, firms such as Honda, Ford, and Toyota are pursuing a strategy of establishing top-to-bottom design and production facilities in each of these regions so that they can better serve local demands. Although such customization brings benefits, it also limits the ability of a firm to realize significant scale economies and location economies.

In addition, pressures for local responsiveness imply that it may not be possible to leverage skills and products associated with a firm's core competencies wholesale from one nation to another. Concessions often have to be made to local conditions. Despite being depicted as "poster boy" for the proliferation of standardized global products, even McDonald's has found that it has to customize its product offerings (i.e., its menu) to account for national differences in tastes and preferences.

How do differences in the strength of pressures for cost reductions versus those for local responsiveness affect a firm's choice of strategy? Firms typically choose among four main strategic postures when competing internationally. These can be characterized as a global standardization strategy, a localization strategy, a transnational strategy, and an international strategy.[33] The appropriateness of each strategy varies given the extent of pressures for cost reductions and local responsiveness. Figure 13.7 illustrates the conditions under which each of these strategies is most appropriate.

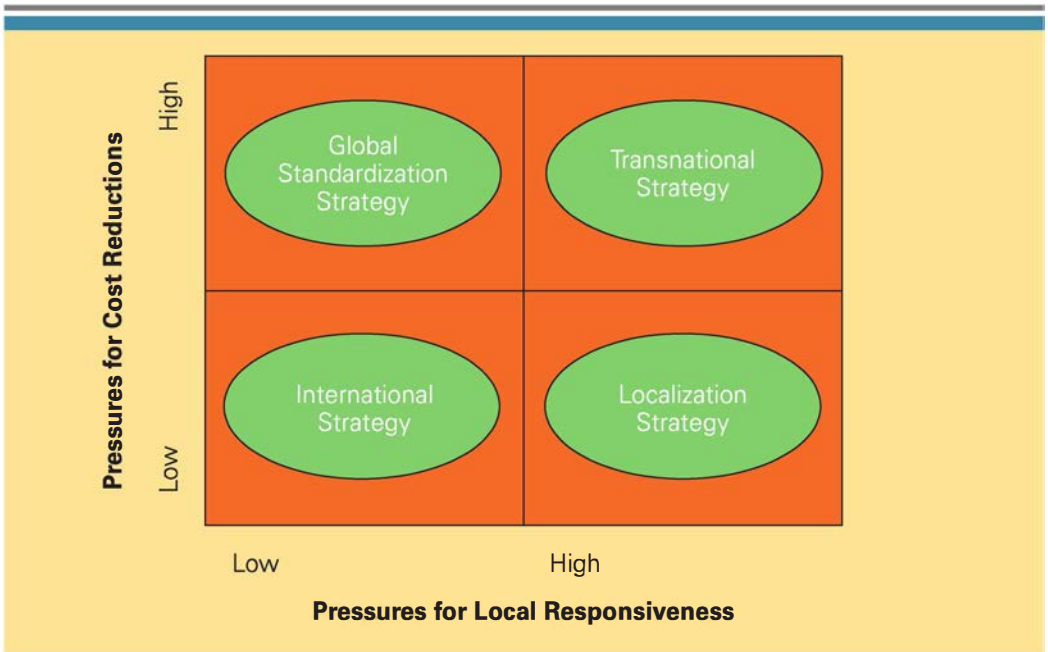


FIGURE 13.7
Four Basic Strategies



MANAGEMENT FOCUS

Vodafone in Japan

In 2002 Vodafone Group of the United Kingdom, the world's largest provider of wireless telephone service, made a big splash by paying $14 billion to acquire J-Phone, the No. 3 player in Japan's fast-growing market for wireless communications services. J-Phone was considered a hot property, having just launched Japan's first cell phones that were embedded with digital cameras, winning over large numbers of young people who wanted to e-mail photos to their friends. Four years later, after losing market share to local competitors, Vodafone sold J-Phone and took an $8.6 billion charge against earnings related to the sale. What went wrong?

According to analysts, Vodafone's mistake was to focus too much on building a global brand and not enough on local market conditions in Japan. In the early 2000s, Vodafone's vision was to offer consumers in different countries the same technology, so that they could take their phones with them when they traveled across international borders. The problem, however, was that Japan's most active cell phone users, many of them young people who don't regularly travel abroad, care far less about this capability than about game playing and other features that are embedded in their cell phones.

Vodafone's emphasis on global services meant that it delayed its launch in Japan of phones that use 3G technology, which allowed users to do things such as watch video clips and teleconference on their cell phones. The company, in line with its global branding ambitions, had decided to launch 3G cell phones that worked both inside and outside Japan. The delay was costly. Its Japanese competitors launched 3G phones a year ahead of Vodafone. Although these phones only worked in Japan, they rapidly gained share as consumers adopted these leading-edge devices. When Vodafone did finally introduce a 3G phone, design problems associated with making a phone that worked globally meant that the supply of phones was limited, and the launch fizzled despite strong product reviews, simply because consumers could not get the phones.[34]

GLOBAL STANDARDIZATION STRATEGY

Firms that pursue a **global standardization strategy** focus on increasing profitability and profit growth by reaping the cost reductions that come from economies of scale, learning effects, and location economies; that is, their strategic goal is to pursue a low-cost strategy on a global scale. The production, marketing, and R&D activities of firms pursuing a global standardization strategy are concentrated in a few favorable locations. Firms pursuing a global standardization strategy try not to customize their product offering and marketing strategy to local conditions because customization involves shorter production runs and the duplication of functions, which tends to raise costs. Instead, they prefer to market a standardized product worldwide so that they can reap the maximum benefits from economies of scale and learning effects. They also tend to use their cost advantage to support aggressive pricing in world markets.

This strategy makes most sense when there are strong pressures for cost reductions and demands for local responsiveness are minimal. Increasingly, these conditions prevail in many industrial goods industries, whose products often serve universal needs. In the semiconductor industry, for example, global standards have emerged, creating enormous demands for standardized global products. Accordingly, companies such as Intel, Texas Instruments, and Motorola all pursue a global standardization strategy. However, these conditions are not yet found in many consumer goods markets, where demands for local responsiveness remain high. The strategy is inappropriate when demands for local responsiveness are high. The experience of Vodafone, which is discussed in the accompanying Management Focus, illustrates what can happen when a global standardization strategy does not match market realities.

LOCALIZATION STRATEGY

A **localization strategy** focuses on increasing profitability by customizing the firm's goods or services so that they provide a good match to tastes and preferences in different national markets. Localization is most appropriate when there are substantial differences across nations with regard to consumer tastes and preferences, and where cost pressures are not too intense. By customizing the product offering to local demands, the firm increases the value of that product in the local market. On the downside, because it involves some duplication of functions and smaller production runs, customization limits the ability of the firm to capture the cost reductions associated with mass-producing a standardized product for global consumption. The strategy may make sense, however, if the added value associated with local customization supports higher pricing, which enables the firm to recoup its higher costs, or if it leads to substantially greater local demand, enabling the firm to reduce costs through the attainment of some scale economies in the local market.

At the same time, firms still have to keep an eye on costs. Firms pursuing a localization strategy still need to be efficient and, whenever possible, to capture some scale economies from their global reach. As noted earlier, many automobile companies have found that they have to customize some of their product offerings to local market demands—for example, producing large pickup trucks for U.S. consumers and small fuel-efficient cars for Europeans and Japanese. At the same time, these multinationals try to get some scale economies from their global volume by using common vehicle platforms and components across many different models, and manufacturing those platforms and components at efficiently scaled factories that are optimally located. By designing their products in this way, these companies have been able to localize their product offering, yet simultaneously capture some scale economies, learning effects, and location economies.

TRANSNATIONAL STRATEGY

We have argued that a global standardization strategy makes most sense when cost pressures are intense, and demands for local responsiveness limited. Conversely, a localization strategy makes most sense when demands for local responsiveness are high, but cost pressures are moderate or low. What happens, however, when the firm simultaneously faces both strong cost pressures and strong pressures for local responsiveness? How can managers balance the competing and inconsistent demands such divergent pressures place on the firm? According to some researchers, the answer is to pursue what has been called a transnational strategy.

Two of these researchers, Christopher Bartlett and Sumantra Ghoshal, argue that in today's global environment, competitive conditions are so intense that to survive, firms must do all they can to respond to pressures for cost reductions and local responsiveness. They must try to realize location economies and experience effects, to leverage products internationally, to transfer core competencies and skills within the company, and to simultaneously pay attention to pressures for local responsiveness.[35] Bartlett and Ghoshal note that in the modern multinational enterprise, core competencies and skills do not reside just in the home country but can develop in any of the firm's worldwide operations. Thus, they maintain that the flow of skills and product offerings should not be all one way, from home country to foreign subsidiary. Rather, the flow should also be from foreign subsidiary to home country and from foreign subsidiary to foreign subsidiary. Transnational enterprises, in other words, must also focus on leveraging subsidiary skills.

In essence, firms that pursue a **transnational strategy** are trying to simultaneously achieve low costs through location economies, economies of scale, and learning effects; differentiate their product offering across geographic markets to account for local differences; and foster a multidirectional flow of skills between different subsidiaries in the firm's global network of operations. As attractive as this may sound in theory, the strategy is not an easy one to pursue since it places conflicting demands on the company. Differentiating the product to respond to local demands in different geographic markets

raises costs, which runs counter to the goal of reducing costs. Companies such as Ford and ABB (one of the world's largest engineering conglomerates) have tried to embrace a transnational strategy and found it difficult to implement.

How best to implement a transnational strategy is one of the most complex questions that large multinationals are grappling with today. Few if any enterprises have perfected this strategic posture. But some clues as to the right approach can be derived from a number of companies. For an example, consider the case of Caterpillar. The need to compete with low-cost competitors such as Komatsu of Japan forced Caterpillar to look for greater cost economies. However, variations in construction practices and government regulations across countries mean that Caterpillar also has to be responsive to local demands. Therefore, Caterpillar confronted significant pressures for cost reductions *and* for local responsiveness.

To deal with cost pressures, Caterpillar redesigned its products to use many identical components and invested in a few large-scale component manufacturing facilities, sited at favorable locations, to fill global demand and realize scale economies. At the same time, the company augments the centralized manufacturing of components with assembly plants in each of its major global markets. At these plants, Caterpillar adds local product features, tailoring the finished product to local needs. Thus, Caterpillar is able to realize many of the benefits of global manufacturing while reacting to pressures for local responsiveness by differentiating its product among national markets.[36] Caterpillar started to pursue this strategy in 1979 and by 2000 had succeeded in doubling output per employee, significantly reducing its overall cost structure in the process. Meanwhile, Komatsu and Hitachi, which are still wedded to a Japan-centric global strategy, have seen their cost advantages evaporate and have been steadily losing market share to Caterpillar.

Changing a firm's strategic posture to build an organization capable of supporting a transnational strategy is a complex and challenging task. Some would say it is too complex, because the strategy implementation problems of creating a viable organizational structure and control systems to manage this strategy are immense.

INTERNATIONAL STRATEGY

Sometimes it is possible to identify multinational firms that find themselves in the fortunate position of being confronted with low cost pressures and low pressures for local responsiveness. Many of these enterprises have pursued an **international strategy**, taking products first produced for their domestic market and selling them internationally with only minimal local customization. The distinguishing feature of many such firms is that they are selling a product that serves universal needs, but they do not face significant competitors, and thus unlike firms pursuing a global standardization strategy, they are not confronted with pressures to reduce their cost structure. Xerox found itself in this position in the 1960s after its invention and commercialization of the photocopier. The technology underlying the photocopier was protected by strong patents, so for several years Xerox did not face competitors—it had a monopoly. The product serves universal needs, and it was highly valued in most developed nations. Thus, Xerox was able to sell the same basic product the world over, charging a relatively high price for that product. Since Xerox did not face direct competitors, it did not have to deal with strong pressures to minimize its cost structure.

Enterprises pursuing an international strategy have followed a similar developmental pattern as they expanded into foreign markets. They tend to centralize product development functions such as R&D at home. However, they also tend to establish manufacturing and marketing functions in each major country or geographic region in which they do business. The resulting duplication can raise costs, but this is less of an issue if the firm does not face strong pressures for cost reductions. Although they may undertake some local customization of product offering and marketing strategy, this tends to be rather limited in scope. Ultimately, in most firms that pursue an international strategy, the head office retains fairly tight control over marketing and product strategy.

Other firms that have pursued this strategy include Procter & Gamble and Microsoft. Historically, Procter & Gamble developed innovative new products in Cincinnati and then transferred them wholesale to local markets (see the accompanying Management Focus). Similarly, the bulk of Microsoft's product development work occurs in Redmond, Washington, where the company is headquartered. Although some localization work is undertaken elsewhere, this is limited to producing foreign-language versions of popular Microsoft programs.

THE EVOLUTION OF STRATEGY

The Achilles' heel of the international strategy is that over time, competitors inevitably emerge, and if managers do not take proactive steps to reduce their firm's cost structure, it will be rapidly outflanked by efficient global competitors. This is exactly what happened to Xerox. Japanese companies such as Canon ultimately invented their way around Xerox's patents, produced their own photocopiers in very efficient manufacturing plants, priced them below Xerox's products, and rapidly took global market share from Xerox. In the final analysis, Xerox's demise was not due to the emergence of competitors, for ultimately that was bound to occur, but due to its failure to proactively reduce its cost structure in advance of the emergence of efficient global competitors. The message in this story is that an international strategy may not be viable in the long term, and to survive, firms need to shift toward a global standardization strategy or a transnational strategy in advance of competitors (see Figure 13.8).

The same can be said about a localization strategy. Localization may give a firm a competitive edge, but if it is simultaneously facing aggressive competitors, the company will also have to reduce its cost structure, and the only way to do that may be to shift toward a transnational strategy. This is what Procter & Gamble has been doing (see the accompanying Management Focus). Thus, as competition intensifies, international and localization strategies tend to become less viable, and managers need to orientate their companies toward either a global standardization strategy or a transnational strategy.

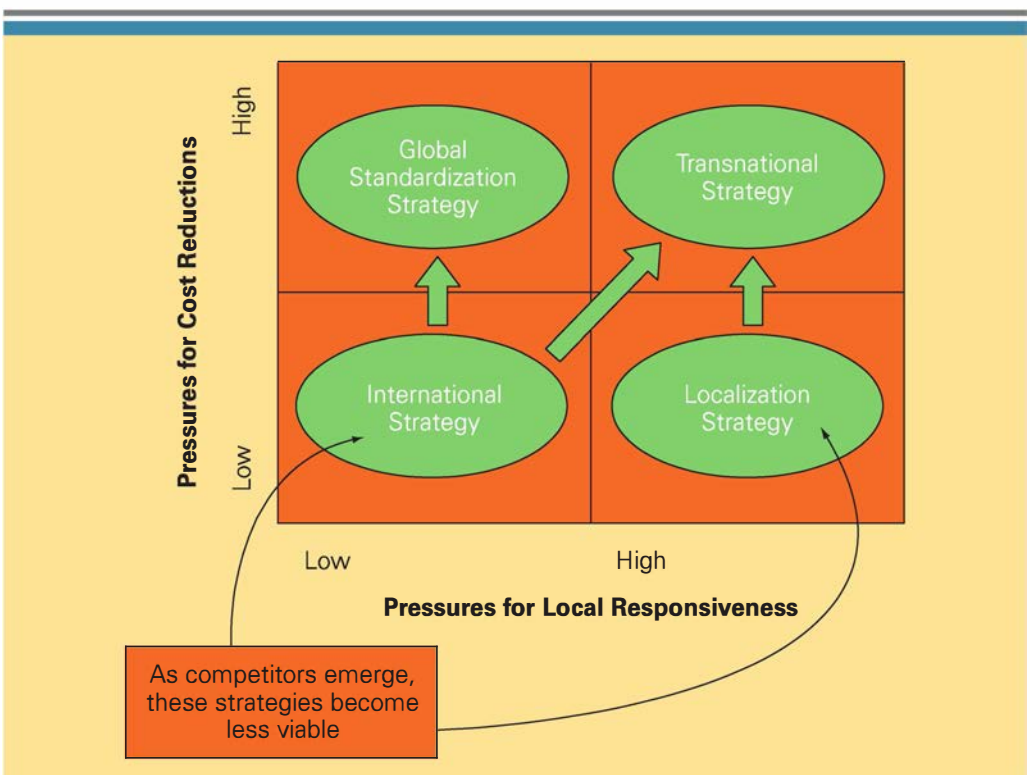


FIGURE 13.8

Changes in Strategy over Time



MANAGEMENT FOCUS

Evolution of Strategy at Procter & Gamble

Founded in 1837, Cincinnati-based Procter & Gamble has long been one of the world's most international companies. Today P&G is a global colossus in the consumer products business with annual sales in excess of $50 billion, some 54 percent of which are generated outside of the United States. P&G sells more than 300 brands—including Ivory soap, Tide, Pampers, IAM pet food, Crisco, and Folgers—to consumers in 160 countries. Historically the strategy at P&G was well established. The company developed new products in Cincinnati and then relied on semiautonomous foreign subsidiaries to manufacture, market, and distribute those products in different nations. In many cases, foreign subsidiaries had their own production facilities and tailored the packaging, brand name, and marketing message to local tastes and preferences. For years this strategy delivered a steady stream of new products and reliable growth in sales and profits. By the 1990s, however, profit growth at P&G was slowing.

The essence of the problem was simple; P&G's costs were too high because of extensive duplication of manufacturing, marketing, and administrative facilities in different national subsidiaries. The duplication of assets made sense in the world of the 1960s, when national markets were segmented from each other by barriers to cross-border trade. Products produced in Great Britain, for example, could not be sold economically in Germany due to high tariff duties levied on imports into Germany. By the 1980s, however, barriers to cross-border trade were falling rapidly worldwide and fragmented national markets were merging into larger regional or global markets. Also, the retailers through which P&G distributed its products were growing larger and more global, such as Wal-Mart, Tesco from the United Kingdom, and Carrefour from France. These emerging global retailers were demanding price discounts from P&G.

In the 1990s P&G embarked on a major reorganization in an attempt to control its cost structure and recognize the new reality of emerging global markets. The company shut down some 30 manufacturing plants around the globe, laid off 13,000 employees, and concentrated production in fewer plants that could better realize economies of scale and serve regional markets. It wasn't enough! Profit growth remained sluggish so in 1999 P&G launched its second reorganization of the decade. Named "Organization 2005," the goal was to transform P&G into a truly global company. The company tore up its old organization, which was based on countries and regions, and replaced it with one based on seven self-contained global business units, ranging from baby care to food products. Each business unit was given complete responsibility for generating profits from its products, and for manufacturing, marketing, and product development. Each business unit was told to rationalize production, concentrating it in fewer larger facilities; to try to build global brands wherever possible, thereby eliminating marketing difference between countries; and to accelerate the development and launch of new products. P&G announced that as a result of this initiative, it would close another 10 factories and lay off 15,000 employees, mostly in Europe where there was still extensive duplication of assets. The annual cost savings were estimated to be about $800 million. P&G planned to use the savings to cut prices and increase marketing spending in an effort to gain market share, and thus further lower costs through the attainment of scale economies. This time the strategy seemed to be working. For most of the 2000s P&G reported strong growth in both sales and profits. Significantly, P&G's global competitors, such as Unilever, Kimberly-Clark, and Colgate-Palmolive, were struggling during the same time period.[37]

CHAPTER SUMMARY

This chapter reviewed basic principles of strategy and the various ways in which firms can profit from global expansion, and it looked at the strategies that firms that compete globally can adopt. The chapter made the following points:

1. A strategy can be defined as the actions that managers take to attain the goals of the firm. For most firms, the preeminent goal is to maximize shareholder value. Maximizing shareholder value requires firms to focus on increasing their profitability and the growth rate of profits over time.
2. International expansion may enable a firm to earn greater returns by transferring the product offerings derived from its core competencies to markets where indigenous competitors lack those product offerings and competencies.
3. It may pay a firm to base each value creation activity it performs at that location where factor conditions are most conducive to the performance of that activity. We refer to this strategy as focusing on the attainment of location economies.
4. By rapidly building sales volume for a standardized product, international expansion can assist a firm in moving down the experience curve by realizing learning effects and economies of scale.
5. A multinational firm can create additional value by identifying valuable skills created within its foreign subsidiaries and leveraging those skills within its global network of operations.
6. The best strategy for a firm to pursue often depends on a consideration of the pressures for cost reductions and for local responsiveness.
7. Firms pursuing an international strategy transfer the products derived from core competencies to foreign markets, while undertaking some limited local customization.
8. Firms pursuing a localization strategy customize their product offering, marketing strategy, and business strategy to national conditions.
9. Firms pursuing a global standardization strategy focus on reaping the cost reductions that come from experience curve effects and location economies.
10. Many industries are now so competitive that firms must adopt a transnational strategy. This involves a simultaneous focus on reducing costs, transferring skills and products, and boosting local responsiveness. Implementing such a strategy may not be easy.

Critical Thinking and Discussion Questions

1. In a world of zero transportation costs, no trade barriers, and nontrivial differences between nations with regard to factor conditions, firms must expand internationally if they are to survive. Discuss.
2. Plot the position of the following firms on Figure 13.6: Procter & Gamble, IBM, Nokia, Coca-Cola, Dow Chemicals, US Steel, McDonald's. In each case justify your answer.
3. In what kind of industries does a localization strategy make sense? When does a global standardization strategy make most sense?
4. Reread the Management Focus on Procter & Gamble and then answer the following questions:
   a. What strategy was Procter & Gamble pursuing when it first entered foreign markets in the period up until the 1980s?
   b. Why do you think this strategy became less viable in the 1990s?
   c. What strategy does P&G appear to be moving toward? What are the benefits of this strategy? What are the potential risks associated with it?
5. What do you see as the main organizational problems that are likely to be associated with implementation of a transnational strategy?

Research Task globalEDGE globaledge.msu.edu

The Strategy of International Business

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The globalization of multinational corporations impacts the product and service choices available to customers. As such, several classifications and rankings of multinational corporations are prepared by a variety of sources. Find the *Global 2000* rankings publish by Forbes and identify the criteria used in evaluating top global companies. Extract the ranking of the top 20 companies, paying particular attention to the home countries, industries, and asset level represented. Based on the data gathered, what generalizations can you make?

Exercise 2

The top management of your company, a manufacturer and marketer of wireless devices, has decided to pursue international expansion opportunities in Africa. In order to achieve some economies of scale, your strategy is to minimize local adaptation. Focusing on the African country of your choice, prepare an executive summary that features aspects of the product where standardization will simply not be possible, and adaptation to local conditions will be essential.

CLOSING CASE

The Evolving Strategy at IBM

IBM CEO Sam Palmisano likes to talk about the evolution of global strategy at one of the world's largest computer enterprises. According to Palmisano, when IBM first started to expand internationally, it did so in the classic "international" pattern of many enterprises, undertaking most of its activities at home, and selling its products internationally through overseas sales offices. By the time Palmisano joined IBM in 1972, however, it had already moved away from this model, and was by then a classic "multinational" enterprise, with mini IBMs in major national markets around the world. This structure made sense for IBM in the 1970s, given that many markets were still segmented from each other by high barriers to cross-border trade, and given that national differences in business practices often required considerable localization.

In recent decades, however, IBM has been moving away from this model and toward one that Palmisano characterizes as a "globally integrated enterprise." In his words: "We are locating work and operations anywhere in the world based on economics, expertise, and the right business environment. We are integrating those operations horizontally and globally. We used to have separate supply chains in different markets. Now we have one supply chain, a global one. Our R&D has been global for many years, with research and software development carried out in labs around the world. But in our professional services businesses, where we used to think about our human capital—our people—in terms of countries, and regions, and business units, we now manage and deploy them as one global asset."

Thus, today's IBM locates its semiconductor R&D and manufacturing operation in upstate New York and Vermont, its global procurement center is in China. Global services delivery is in India, while many of the services that support IBM's external and internal websites are in places like Ireland and Brazil. The people at each of these centers are not focused on their national markets; they are leading integrated global operations.

This strategic shift was a response to three things: the globalization of the world economy, the global nature of many of IBM's customers, who were themselves shifting toward a global integration strategy, and the emergence of fierce competition from enterprises in emerging markets such as China and India. Take India as an example; in the 1990s a trio of Indian outsourcing firms—Tata Consulting Services, Infosys, and Wipro—started to take share away from IBM in its core information technology services business. The Indians enjoyed an advantaged based on a large supply of highly educated but relatively inexpensive engineering and

managerial talent. IBM believed that to compete, it had to adopt the low-cost model being pioneered in India. So in the mid-2000s, it bought Daksh, an Indian firm that was a smaller version of India's big three information technology services firms. IBM has invested heavily in its Indian unit, building it into a large global business with leading market share that now competes effectively on cost and quality against its Indian rivals. While Palmisano notes that the original motivation for expanding in India was to gain access to low-cost labor, he now argues that the skill base in India is just as important, if not more so. IBM can find a large supply of highly skilled people in India who can staff its global services operations and move seamlessly around the world. It doesn't hurt that most Indians have a good command of the English language, which has become the de facto language of business in much of the world.

Looking forward, Palmisano stresses that IBM is still fairly early in its journey to become a fully integrated global enterprise. The big thrust going forward will be on developing the human capital of the enterprise—helping to produce managers and engineers who see themselves as global professionals and global citizens, who are able to move effortlessly around the world, and do business effectively in wide range of national contexts.[38]

Case Discussion Questions

1. In the 1970s and 1980s Sam Palmisano states that IBM was organized as a classic multinational enterprise. What does this mean? Why do you think IBM was organized that way? What were the advantages of this kind of strategic orientation?
2. By the 1990s the classic multinational strategic orientation was no longer working well for IBM. Why not?
3. What are the strategic advantages to IBM of its globally integrated enterprise strategy? What kind of organizational changes do you think had to be made at IBM to make this strategy a reality?
4. In terms of the strategic choice framework introduced in this chapter, what strategy do you think IBM is pursuing today?

Notes

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14. Example is based on C. S. Trager, "Enter the Mini-Multinational," *Northeast International Business*, March 1989, pp. 13–14.
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14 The Organization of International Business

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Explain what is meant by organization architecture.
- **LO2** Describe the different organizational choices that can be made in an international business.
- **LO3** Explain how organization can be matched to strategy to improve the performance of an international business.
- **LO4** Discuss what is required for an international business to change its organization so that it better matches its strategy.

The Evolution of Organization at Philips

Established in 1891 in Holland, Philips Electronics NV is one of the world's oldest multinationals. The company began making lighting products and over time diversified into a range of businesses that included domestic appliances, consumer electronics, and health care products. From the beginning, Holland's small domestic market created pressures for Philips to look to foreign markets for growth. By the start of the World War II, Philips already had a global presence. During the war, Holland was occupied by Germany. By necessity, the company's national organizations in countries such as Britain, Australia, Brazil, Canada, and the United States gained considerable autonomy during this period.

After the war, a structure based on strong national organizations remained in place. Each national organization was in essence a self-contained entity that was responsible for much of its own manufacturing, marketing, and sales. Most R&D activities, however, were centralized at Philips' headquarters in Eindhoven, Holland. Reflecting this, several product divisions were created. Based in Eindhoven, the product divisions developed technologies and products, which were then made and sold by the different national organizations. During this period, the career track of most senior managers at Philips involved significant postings in various national organizations around the world.

For several decades this organizational arrangement worked well. It allowed Philips to customize its product offerings, sales, and marketing efforts to the conditions that existed in different national markets. By the 1970s, however, flaws were appearing in the approach. The structure involved significant duplication of activities around the world, particularly in manufacturing, which created an intrinsically high-cost structure. When trade barriers were high, this did not matter so much, but by the 1970s trade barriers were starting to fall and competitors, including Sony and Matsushita from Japan, General Electric from the United States, and Samsung from Korea, were gaining share by serving increasingly global markets from centralized production facilities where they could achieve greater scale economies and hence lower cost.

Philips' response was to try to tilt the balance of power in its structure away from national organizations



and toward the product divisions. International production centers were established under the direction of the product divisions. The national organizations, however, remained responsible for local marketing and sales, and they often maintained control over some local production facilities. One problem Philips faced in trying to change its structure at this time was that most senior managers had come up through the national organizations. Consequently, they were loyal to them and tended to protect their autonomy. Despite several reorganization efforts, the national organizations remained a strong influence at Philips until the 1990s.

In the mid-1990s Cor Boonstra became CEO. He famously described the company's organization structure as a "plate of spaghetti" and asked how Philips could compete with 350 companies around the world and significant duplication of manufacturing and marketing efforts across nations. Boonstra instituted a radical reorganization. He replaced the company's 21 product divisions with just seven global business divisions, making them responsible for global product development, production, and marketing. The heads of the divisions reported directly to him, while the national organizations reported to the divisions. The national organizations remained responsible for local sales and local marketing efforts, but after this reorganization they finally lost their historic sway on the company.

Philips, however, continued to underperform its global rivals. By 2008, Gerard Kleisterless, who succeeded Boonstra as CEO in 2001, decided Philips was still not sufficiently focused on global markets. He reorganized yet again, this time around just three global divisions, health care, lighting, and consumer lifestyle (which included the company's electronics businesses). The divisions were responsible for product strategy, global marketing, and shifting production to low-cost locations (or outsourcing production). The divisions also took over some sales responsibilities, particularly dealing with global retail chains such as Walmart, Tesco, and Carrefour. To accommodate national differences, however, some sales and marketing activities remained located at the national organizations.[1]

Introduction

The story of Philips, which is profiled in the opening case, is similar to that of many multinationals over the past four decades. Originally Philips pursued a localization strategy (see Chapter 13). It implemented this strategy through strong national organizations. By the 1990s, however, falling trade barriers had resulted in the creation of large global markets. In response, Philips shifted its strategy, adopting more of a transnational posture. It developed and produced standardized products from DVD players and cell phones to MRI systems and lights, which it sold all over the world. Those products were manufactured at centralized locations to attain scale economies and lower costs. To implement this strategy, Philips had to change its organization structure, shifting away from strong national organizations and toward global product divisions. In other words, its organization structure had to match its new strategy. As the case describes, this process of reorganization was not easy and took years to push through.

As suggested by the Philips example, this chapter is concerned with identifying the organization architecture that international businesses use to manage and direct their global operations. By **organizational architecture** we mean the totality of a firm's organization, including formal organization structure, control systems and incentives, processes, organizational culture, and people. The core argument outlined in this chapter is that superior enterprise profitability requires three conditions to be fulfilled. First, the different elements of a firm's organizational architecture must be internally consistent. For example, the control and incentive systems used in the firm must be consistent with the structure of the enterprise. Second, the organizational architecture must match or fit the strategy of the firm—strategy and architecture must be consistent.[2] For example, if a firm is pursuing a global standardization strategy but it has the wrong kind of organization architecture in place, it is unlikely that it will be able to execute that strategy effectively and poor performance may result. The strategy and architecture of the firm must not only be consistent with each other, but they also must make sense given the competitive conditions prevailing in the firm's markets—strategy, architecture, and competitive environment must all be consistent. For example, a firm pursuing a localization strategy might have the right kind of organizational architecture in place for that strategy. However, if it competes in markets where cost pressures are intense and demands for local responsiveness are low, it will still have inferior performance because a global standardization strategy is more appropriate in such an environment.

To explore the issues illustrated by examples such as Philips NV, this chapter opens by discussing in more detail the concepts of organizational architecture and fit. Next it turns to a more detailed exploration of various components of architecture—structure, control systems and incentives, organization culture, and processes—and explains how these components must be internally consistent. (We discuss the "people" component of architecture in Chapter 19, when we discuss human resource strategy in the multinational firm.) After reviewing the various components of architecture, we look at the ways in which architecture can be matched to strategy and the competitive environment to achieve high performance. The chapter closes with a discussion of organizational change, for as the Philips example illustrates, periodically firms have to change their organization so that it matches new strategic and competitive realities.

LO1 Organizational Architecture

As noted in the introduction, the term *organizational architecture* refers to the totality of a firm's organization, including formal organizational structure, control systems and incentives, organizational culture, processes, and people.[3] Figure 14.1 illustrates these different elements. By **organizational structure**, we mean three things: First, the formal division of the organization into subunits such as product divisions, national operations, and functions (most organizational charts display this aspect of structure); second, the

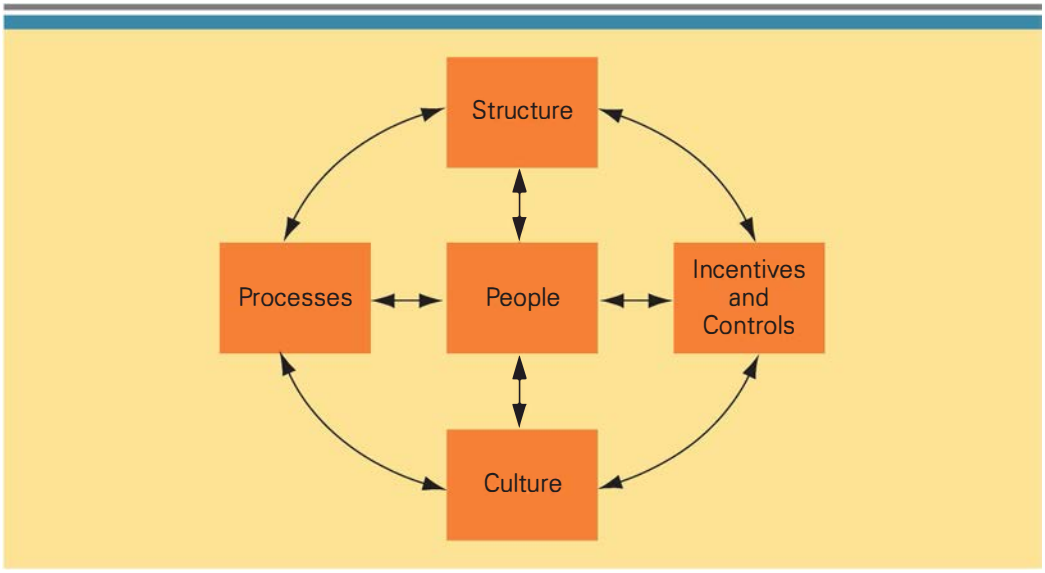


FIGURE 14.1
Organization Architecture

location of decision-making responsibilities within that structure (e.g., centralized or decentralized); and third, the establishment of integrating mechanisms to coordinate the activities of subunits, including cross-functional teams and or pan-regional committees.

Control systems are the metrics used to measure the performance of subunits and make judgments about how well managers are running those subunits. For example, historically Unilever measured the performance of national operating subsidiary companies according to profitability—profitability was the metric. **Incentives** are the devices used to reward appropriate managerial behavior. Incentives are very closely tied to performance metrics. For example, the incentives of a manager in charge of a national operating subsidiary might be linked to the performance of that company. Specifically, she might receive a bonus if her subsidiary exceeds its performance targets.

Processes are the manner in which decisions are made and work is performed within the organization. Examples are the processes for formulating strategy, for deciding how to allocate resources within a firm, or for evaluating the performance of managers and giving feedback. Processes are conceptually distinct from the location of decision-making responsibilities within an organization, although both involve decisions. While the CEO might have ultimate responsibility for deciding what the strategy of the firm should be (i.e., the decision-making responsibility is centralized), the process he or she uses to make that decision might include the solicitation of ideas and criticism from lower-level managers.

Organizational culture refers to the norms and value systems that are shared among the employees of an organization. Just as societies have cultures (see Chapter 4 for details), so do organizations. Organizations are societies of individuals who come together to perform collective tasks. They have their own distinctive patterns of culture and subculture.[4] As we shall see, organizational culture can have a profound impact on how a firm performs. Finally, by **people** we mean not just the employees of the organization, but also the strategy used to recruit, compensate, and retain those individuals and the type of people that they are in terms of their skills, values, and orientation (discussed in depth in Chapter 19).

As illustrated by the arrows in Figure 14.1, the various components of an organization's architecture are not independent of each other: Each component shapes, and is shaped by, other components of architecture. An obvious example is the strategy regarding people. This can be used proactively to hire individuals whose internal values are consistent with those that the firm wishes to emphasize in its organization culture. Thus, the people component of architecture can be used to reinforce (or not) the prevailing culture of the organization. For example, Unilever has historically made an effort to hire managers who were sociable and placed a high value on consensus and cooperation,

values that the enterprise wished to emphasize in its own culture.[5] If a firm is going to maximize its profitability, it must pay close attention to achieving internal consistency between the various components of its architecture.

LO2 Organizational Structure

Organizational structure can be thought of in terms of three dimensions: (1) **vertical differentiation**, which refers to the location of decision-making responsibilities within a structure; (2) **horizontal differentiation**, which refers to the formal division of the organization into subunits; and (3) **integrating mechanisms**, which are mechanisms for coordinating subunits.

VERTICAL DIFFERENTIATION: CENTRALIZATION AND DECENTRALIZATION

A firm's vertical differentiation determines where in its hierarchy the decision-making power is concentrated.[6] Are production and marketing decisions centralized in the offices of upper-level managers, or are they decentralized to lower-level managers? Where does the responsibility for R&D decisions lie? Are important strategic and financial decisions pushed down to operating units, or are they concentrated in the hands of top management? And so on. There are arguments for both centralization and decentralization.

Arguments for Centralization

There are four main arguments for centralization. First, centralization can facilitate coordination. For example, consider a firm that has a component manufacturing operation in Taiwan and an assembly operation in Mexico. The activities of these two operations may need to be coordinated to ensure a smooth flow of products from the component operation to the assembly operation. This might be achieved by centralizing production scheduling at the firm's head office. Second, centralization can help ensure that decisions are consistent with organizational objectives. When decisions are decentralized to lower-level managers, those managers may make decisions at variance with top management's goals. Centralization of important decisions minimizes the chance of this occurring.

Third, by concentrating power and authority in one individual or a management team, centralization can give top-level managers the means to bring about needed major organizational changes. Fourth, centralization can avoid the duplication of activities that occurs when similar activities are carried on by various subunits within the organization. For example, many international firms centralize their R&D functions at one or two locations to ensure that R&D work is not duplicated. Production activities may be centralized at key locations for the same reason.

Arguments for Decentralization

There are five main arguments for decentralization. First, top management can become overburdened when decision-making authority is centralized, and this can result in poor decisions. Decentralization gives top management time to focus on critical issues by delegating more routine issues to lower-level managers. Second, motivational research favors decentralization. Behavioral scientists have long argued that people are willing to give more to their jobs when they have a greater degree of individual freedom and control over their work. Third, decentralization permits greater flexibility—more rapid response to environmental changes—because decisions do not have to be "referred up the hierarchy" unless they are exceptional in nature. Fourth, decentralization can result in better decisions. In a decentralized structure, decisions are made closer to the spot by individuals who (presumably) have better information than managers several levels up in a hierarchy (for an example of decentralization to achieve this goal, see the Management Focus on Walmart's international division). Fifth, decentralization can increase control.



The International Division at Walmart

When Walmart started to expand internationally in the early 1990s, it decided to set up an international division to oversee the process. The international division was based in Bentonville, Arkansas, at the company headquarters. Today the division oversees operations in 14 countries that collectively generate more than $60 billion in sales. In terms of reporting structure, the division is divided into three regions—Europe, Asia, and the Americas—with the CEO of each region reporting to the CEO of the international division, who in turn reports to the CEO of Walmart.

Initially, the senior management of the international division exerted tight centralized control over merchandising strategy and operations in different countries. The reasoning was straightforward; Walmart's managers wanted to make sure that international stores copied the format for stores, merchandising, and operations that had served the company so well in the United States. They believed, naively perhaps, that centralized control over merchandising strategy and operations was the way to make sure this was the case.

By the late 1990s, with the international division approaching $20 billion in sales, Walmart's managers concluded this centralized approach was not serving them well. Country managers had to get permission from their superiors in Bentonville before changing strategy and operations, and this was slowing decision making. Centralization also produced information overload at the headquarters, and led to some poor decisions. Walmart found that managers in Bentonville were not necessarily the best ones to decide on store layout in Mexico, merchandising strategy in Argentina, or compensation policy in the United Kingdom. The need to adapt merchandising strategy and operations to local conditions argued strongly for greater decentralization.

The pivotal event that led to a change in policy at Walmart was the company's 1999 acquisition of Britain's ASDA supermarket chain. The ASDA acquisition added a mature and successful $14 billion operation to Walmart's international division. The company realized that it was not appropriate for managers in Bentonville to be making all-important decisions for ASDA. Accordingly, over the next few months, John Menzer, CEO of the international division, reduced the number of staff located in Bentonville that were devoted to international operations by 50 percent. Country leaders were given greater responsibility, especially in the area of merchandising and operations. In Menzer's own words, "We were at the point where it was time to break away a little bit. . . . You can't run the world from one place. The countries have to drive the business.... The change has sent a strong message [to country managers] that they no longer have to wait for approval from Bentonville."

Although Walmart has now decentralized decisions within the international division, it is still struggling to find the right formula for managing global procurement. Ideally, the company would like to centralize procurement in Bentonville so that it could use its enormous purchasing power to bargain down the prices it pays suppliers. As a practical matter, however, this has not been easy to attain given that the product mix in Walmart stores has to be tailored to conditions prevailing in the local market. Currently, significant responsibility for procurement remains at the country and regional level. However, Walmart would like to have a global procurement strategy such that it can negotiate on a global basis with key suppliers and can simultaneously introduce new merchandise into its stores around the world.

As merchandising and operating decisions have been decentralized, the international division has increasingly taken on a new role—that of identifying best practices and transferring them between countries. For example, the division has developed a knowledge management system whereby stores in one country, let's say Argentina, can quickly communicate pictures of items, sales data, and ideas on how to market and promote products to stores in another country, such as Japan. The division is also starting to move personnel between stores in different countries as a way of facilitating the flow of best practices across national borders. Finally, the division is at the cutting edge of moving Walmart away from its U.S.-centric mentality and showing the organization that ideas implemented in foreign operations might also be used to improve the efficiency and effectiveness of Walmart's operations at home.[7]

Decentralization can be used to establish relatively autonomous, self-contained subunits within an organization. Subunit managers can then be held accountable for subunit performance. The more responsibility subunit managers have for decisions that impact subunit performance, the fewer excuses they have for poor performance.

Strategy and Centralization in an International Business

The choice between centralization and decentralization is not absolute. Frequently it makes sense to centralize some decisions and to decentralize others, depending on the type of decision and the firm's strategy. Decisions regarding overall firm strategy, major financial expenditures, financial objectives, and legal issues are typically centralized at the firm's headquarters. However, operating decisions, such as those relating to production, marketing, R&D, and human resource management, may or may not be centralized depending on the firm's strategy.

Consider firms pursuing a global standardization strategy. They must decide how to disperse the various value creation activities around the globe so location and experience economies can be realized. The head office must make the decisions about where to locate R&D, production, marketing, and so on. In addition, the globally dispersed web of value creation activities that facilitates a global strategy must be coordinated. All of this creates pressures for centralizing some operating decisions.

In contrast, the emphasis on local responsiveness in firms pursuing a localization strategy creates strong pressures for decentralizing operating decisions to foreign subsidiaries. Firms pursuing an international strategy also tend to maintain centralized control over their core competency and to decentralize other decisions to foreign subsidiaries. Typically, such firms centralize control over R&D in their home country, but decentralize operating decisions to foreign subsidiaries. For example, Microsoft Corporation, which fits the international mode, centralizes its product development activities (where its core competencies lie) at its Redmond, Washington, headquarters and decentralizes marketing activity to various foreign subsidiaries. Thus, while products are developed at home, managers in the various foreign subsidiaries have significant latitude for formulating strategies to market those products in their particular settings.[8]

The situation in firms pursuing a transnational strategy is more complex. The need to realize location and experience curve economies requires some degree of centralized control over global production centers. However, the need for local responsiveness dictates the decentralization of many operating decisions, particularly for marketing, to foreign subsidiaries. Thus, in firms pursuing a transnational strategy, some operating decisions are relatively centralized, while others are relatively decentralized. In addition, global learning based on the multidirectional transfer of skills between subsidiaries, and between subsidiaries and the corporate center, is a central feature of a firm pursuing a transnational strategy. The concept of global learning is predicated on the notion that foreign subsidiaries within a multinational firm have significant freedom to develop their own skills and competencies. Only then can these be leveraged to benefit other parts of the organization. A substantial degree of decentralization is required if subsidiaries are going to have the freedom to do this. For this reason too, the pursuit of a transnational strategy requires a high degree of decentralization.[9]

HORIZONTAL DIFFERENTIATION: THE DESIGN OF STRUCTURE

Horizontal differentiation is concerned with how the firm decides to divide itself into subunits.[10] The decision is normally made on the basis of function, type of business, or geographical area. In many firms, just one of these predominates, but more complex solutions are adopted in others. This is particularly likely in the case of multinational firms, where the conflicting demands to organize the company around different products (to realize location and experience curve economies) and different national markets (to remain locally responsive) must be reconciled.

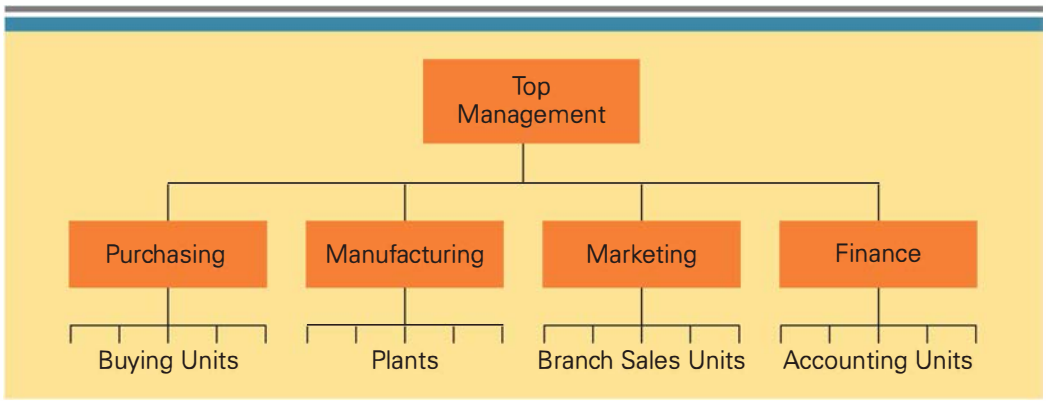


FIGURE 14.2

A Typical Functional Structure

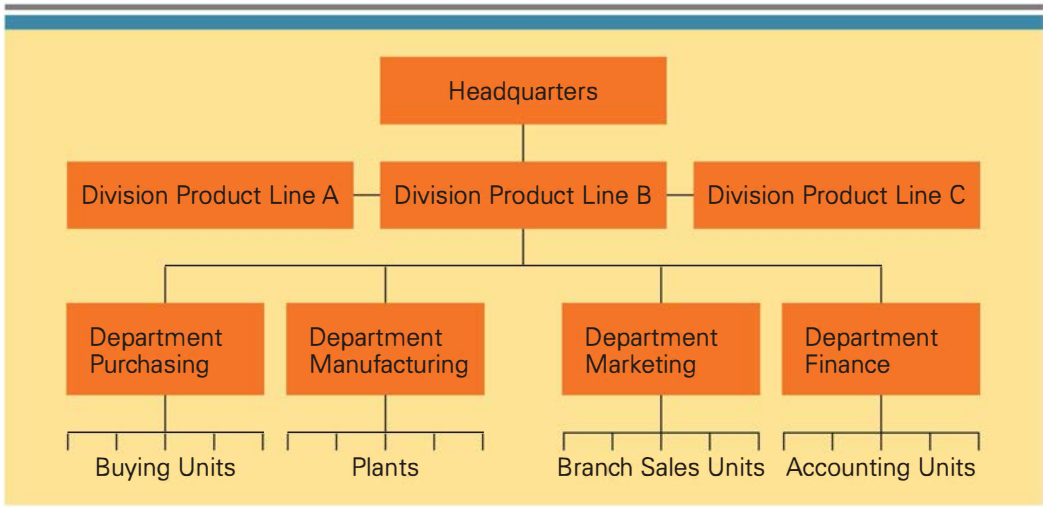


FIGURE 14.3

A Typical Product Divisional Structure

The Structure of Domestic Firms

Most firms begin with no formal structure and are run by a single entrepreneur or a small team of individuals. As they grow, the demands of management become too great for one individual or a small team to handle. At this point the organization is split into functions reflecting the firm's value creation activities (e.g., production, marketing, R&D, sales). These functions are typically coordinated and controlled by top management (see Figure 14.2). Decision making in this functional structure tends to be centralized.

Further horizontal differentiation may be required if the firm significantly diversifies its product offering, which takes the firm into different business areas. For example, Dutch multinational Philips Electronics NV began as a lighting company, but diversification took the company into consumer electronics (e.g., visual and audio equipment), industrial electronics (integrated circuits and other electronic components), and medical systems (MRI scanners and ultrasound systems). In such circumstances, a functional structure can be too clumsy. Problems of coordination and control arise when different business areas are managed within the framework of a functional structure.[11] For one thing, it becomes difficult to identify the profitability of each distinct business area. For another, it is difficult to run a functional department, such as production or marketing, if it is supervising the value creation activities of several business areas.

To solve the problems of coordination and control, at this stage most firms switch to a product divisional structure (see Figure 14.3). With a product divisional structure, each division is responsible for a distinct product line (business area). Thus, Philips created divisions for lighting, consumer electronics, industrial electronics, and medical systems. Each product division is set up as a self-contained, largely autonomous entity with its own functions. The responsibility for operating decisions is typically decentralized to product divisions, which are then held accountable for their performance. Headquarters

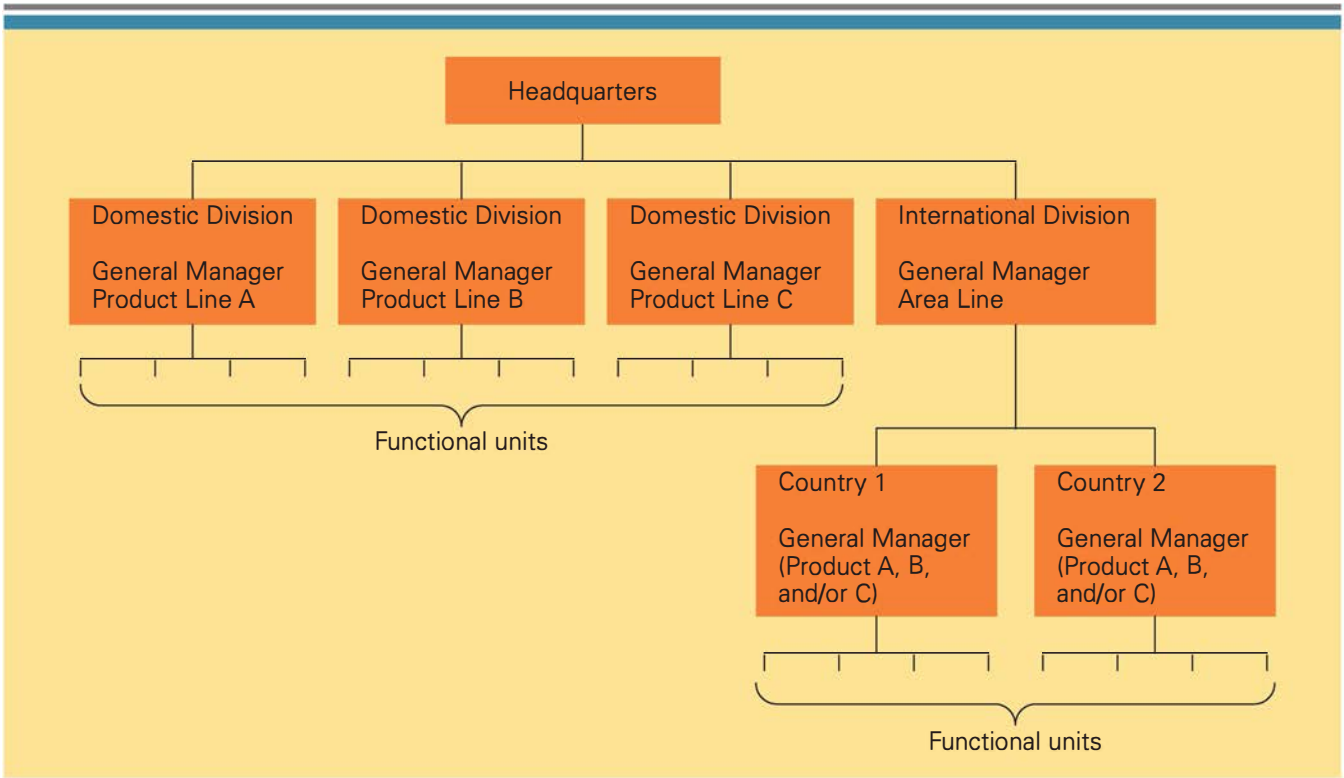


FIGURE 14.4

One Company's International Division Structure

is responsible for the overall strategic development of the firm and for the financial control of the various divisions.

The International Division

When firms initially expand abroad, they often group all their international activities into an **international division**. This has tended to be the case for firms organized on the basis of functions and for firms organized on the basis of product divisions. Regardless of the firm's domestic structure, its international division tends to be organized on geography. Figure 14.4 illustrates this for a firm whose domestic organization is based on product divisions.

Many manufacturing firms expanded internationally by exporting the product manufactured at home to foreign subsidiaries to sell. Thus, in the firm illustrated in Figure 14.4, the subsidiaries in countries 1 and 2 would sell the products manufactured by divisions A, B, and C. In time, however, it might prove viable to manufacture the product in each country, and so production facilities would be added on a country-by-country basis. For firms with a functional structure at home, this might mean replicating the functional structure in every country in which the firm does business. For firms with a divisional structure, this might mean replicating the divisional structure in every country in which the firm does business.

This structure has been widely used; according to a Harvard study, 60 percent of all firms that have expanded internationally have initially adopted it. A good example of a company that uses this structure is Walmart, which created an international division in 1991 to manage its global expansion (Walmart's international division is profiled in the Management Focus). Despite its popularity, an international division structure can give rise to problems.[12] The dual structure it creates contains inherent potential for conflict and coordination problems between domestic and foreign operations. One problem with the structure is that the heads of foreign subsidiaries are not given as much voice in the



FIGURE 14.5
The International Structural Stages Model

organization as the heads of domestic functions (in the case of functional firms) or divisions (in the case of divisional firms). Rather, the head of the international division is presumed to be able to represent the interests of all countries to headquarters. This effectively relegates each country's manager to the second tier of the firm's hierarchy, which is inconsistent with a strategy of trying to expand internationally and build a true multinational organization.

Another problem is the implied lack of coordination between domestic operations and foreign operations, which are isolated from each other in separate parts of the structural hierarchy. This can inhibit the worldwide introduction of new products, the transfer of core competencies between domestic and foreign operations, and the consolidation of global production at key locations so as to realize location and experience curve economies.

As a result of such problems, many firms that continue to expand internationally abandon this structure and adopt one of the worldwide structures discussed next. The two initial choices are a worldwide product divisional structure, which tends to be adopted by diversified firms that have domestic product divisions, and a worldwide area structure, which tends to be adopted by undiversified firms whose domestic structures are based on functions. These two alternative paths of development are illustrated in Figure 14.5. The model in the figure is referred to as the international structural stages model and was developed by John Stopford and Louis Wells.[13]

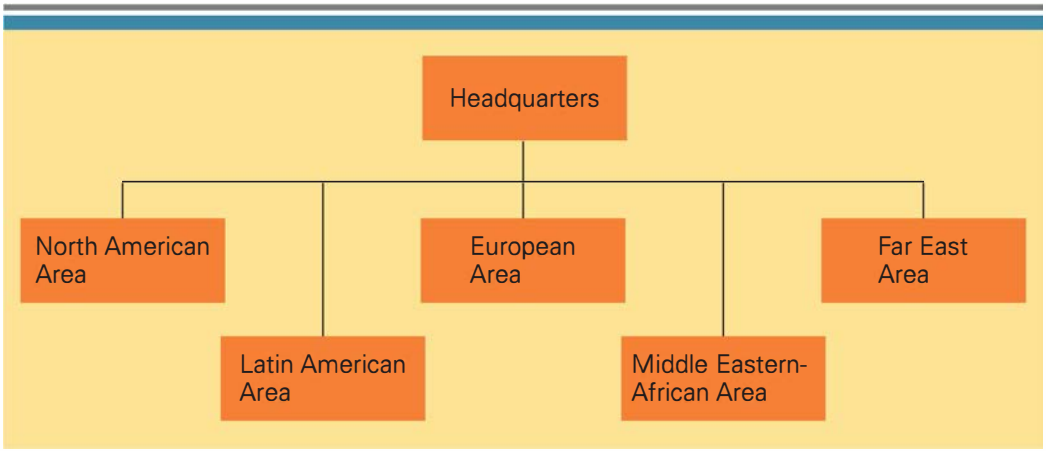
Worldwide Area Structure

A **worldwide area structure** tends to be favored by firms with a low degree of diversification and a domestic structure based on functions (see Figure 14.6). Under this structure, the world is divided into geographic areas. An area may be a country (if the market is large enough) or a group of countries. Each area tends to be a self-contained, largely autonomous entity with its own set of value creation activities (e.g., its own production, marketing, R&D, human resources, and finance functions). Operations authority and strategic decisions relating to each of these activities are typically decentralized to each area, with headquarters retaining authority for the overall strategic direction of the firm and financial control.

This structure facilitates local responsiveness. Because decision-making responsibilities are decentralized, each area can customize product offerings, marketing strategy, and business strategy to the local conditions. However, this structure encourages fragmentation of the organization into highly autonomous entities. This can make it difficult to transfer core competencies and skills between areas and to realize location and experience curve

FIGURE 14.6

A Worldwide Area Structure



economies. In other words, the structure is consistent with a localization strategy, but may make it difficult to realize gains associated with global standardization. Firms structured on this basis may encounter significant problems if local responsiveness is less critical than reducing costs or transferring core competencies for establishing a competitive advantage.

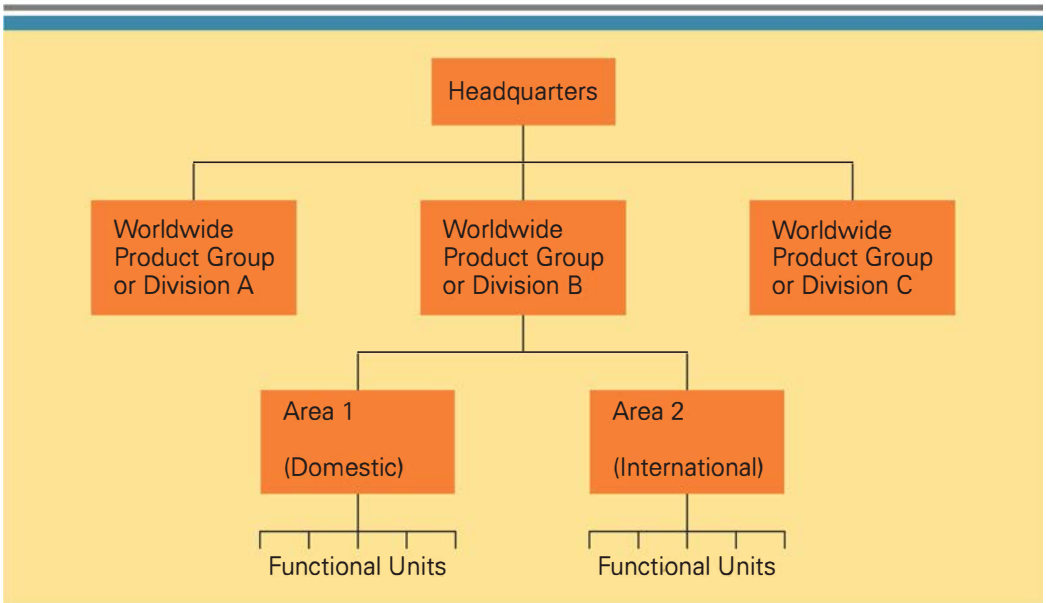
Worldwide Product Divisional Structure

A **worldwide product division structure** tends to be adopted by firms that are reasonably diversified and, accordingly, originally had domestic structures based on product divisions. As with the domestic product divisional structure, each division is a self-contained, largely autonomous entity with full responsibility for its own value creation activities. The headquarters retains responsibility for the overall strategic development and financial control of the firm (see Figure 14.7).

Underpinning the organization is a belief that the value creation activities of each product division should be coordinated by that division worldwide. Thus, the worldwide product divisional structure is designed to help overcome the coordination problems that arise with the international division and worldwide area structures. This structure provides an organizational context that enhances the consolidation of value creation activities at key locations necessary for realizing location and experience curve economies. It also facilitates the transfer of core competencies within a division's worldwide operations and the simultaneous worldwide introduction of new products. The main problem with the structure is the limited voice it gives to area or country managers, since they are seen

FIGURE 14.7

A Worldwide Product Divisional Structure



as subservient to product division managers. The result can be a lack of local responsiveness, which, as Chapter 13 showed, can lead to performance problems.

Global Matrix Structure

Both the worldwide area structure and the worldwide product divisional structure have strengths and weaknesses. The worldwide area structure facilitates local responsiveness, but it can inhibit the realization of location and experience curve economies and the transfer of core competencies between areas. The worldwide product division structure provides a better framework for pursuing location and experience curve economies and for transferring core competencies, but it is weak in local responsiveness. Other things being equal, this suggests that a worldwide area structure is more appropriate if the firm is pursuing a localization strategy, while a worldwide product divisional structure is more appropriate for firms pursuing global standardization or international strategies. However, as we saw in Chapter 13, other things are not equal. As Bartlett and Ghoshal have argued, to survive in some industries, firms must adopt a transnational strategy. That is, they must focus simultaneously on realizing location and experience curve economies, on local responsiveness, and on the internal transfer of core competencies (worldwide learning).[14]

Some firms have attempted to cope with the conflicting demands of a transnational strategy by using a matrix structure. In the classic **global matrix structure**, horizontal differentiation proceeds along two dimensions: product division and geographic area (see Figure 14.8). The philosophy is that responsibility for operating decisions pertaining to a particular product should be shared by the product division and the various areas of the firm. Thus, the nature of the product offering, the marketing strategy, and the business strategy to be pursued in area 1 for the products produced by division A are determined by conciliation between division A and area 1 management. It is believed that this dual decision-making responsibility should enable the firm to simultaneously achieve its particular objectives. In a classic matrix structure, giving product divisions and geographical areas equal status within the organization reinforces the idea of dual responsibility. Individual managers thus belong to two hierarchies (a divisional hierarchy and an area hierarchy) and have two bosses (a divisional boss and an area boss).

The reality of the global matrix structure is that it often does not work as well as the theory predicts. In practice, the matrix often is clumsy and bureaucratic. It can require so many meetings that it is difficult to get any work done. The need to get an area and a product division to reach a decision can slow decision making and produce an inflexible

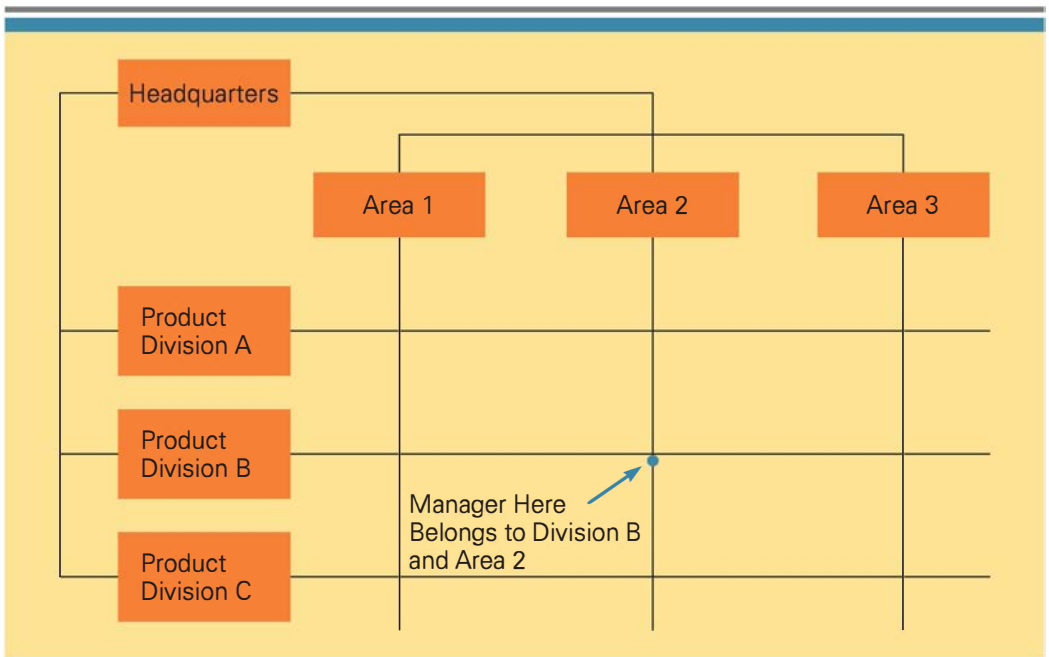


FIGURE 14.8
A Global Matrix Structure



MANAGEMENT FOCUS

The Rise and Fall of Dow Chemical's Matrix Structure

A handful of major players compete head-to-head around the world in the chemical industry. These companies are Dow Chemical and Du Pont of the United States, Great Britain's ICI, and the German trio of BASF, Hoechst AG, and Bayer. The barriers to the free flow of chemical products between nations largely disappeared in the 1970s. This along with the commodity nature of most bulk chemicals has ushered in a prolonged period of intense price competition. In such an environment, the company that wins the competitive race is the one with the lowest costs. Dow Chemical was long among the cost leaders.

For years, Dow's managers insisted that part of the credit should be placed at the feet of its "matrix" organization. Dow's organizational matrix had three interacting elements: functions (e.g., R&D, manufacturing, marketing), businesses (e.g., ethylene, plastics, pharmaceuticals), and geography (e.g., Spain, Germany, Brazil). Managers' job titles incorporated all three elements—for example, plastics marketing manager for Spain—and most managers reported to at least two bosses. The plastics marketing manager in Spain might report to both the head of the worldwide plastics business and the head of the Spanish operations. The intent of the matrix was to make Dow operations responsive to both local market needs and corporate objectives. Thus, the plastics business might be charged with minimizing Dow's global plastics production costs, while the Spanish operation might be charged with determining how best to sell plastics in the Spanish market.

When Dow introduced this structure, the results were less than promising; multiple reporting channels led to confusion and conflict. The large number of bosses made for an unwieldy bureaucracy. The overlapping responsibilities resulted in turf battles and a lack of accountability. Area managers disagreed with managers overseeing business sectors about which plants should be built and where. In short, the structure didn't work. Instead of abandoning the structure, however, Dow decided to see if it could be made more flexible.

Dow's decision to keep its matrix structure was prompted by its move into the pharmaceuticals industry. The company realized that the pharmaceutical business is very different from the bulk chemicals business. In bulk chemicals, the big returns come from achieving economies of scale in production. This dictates establishing large plants in key locations from which regional or global markets can be served. But in pharmaceuticals, regulatory and marketing requirements for drugs vary so much from country to country that local needs are far more important than reducing manufacturing costs through scale economies. A high degree of local responsiveness is essential. Dow realized its pharmaceutical business would never thrive if it were managed by the same priorities as its mainstream chemical operations.

organization unable to respond quickly to market shifts or to innovate. The dual-hierarchy structure can lead to conflict and perpetual power struggles between the areas and the product divisions, catching many managers in the middle. To make matters worse, it can prove difficult to ascertain accountability in this structure. When all critical decisions are the product of negotiation between divisions and areas, one side can always blame the other when things go wrong. As a manager in one global matrix structure, reflecting on a failed product launch, said to the author, "Had we been able to do things our way, instead of having to accommodate those guys from the product division, this would never have happened." (A manager in the product division expressed similar sentiments.) The result of such finger-pointing can be that accountability is compromised, conflict is enhanced, and headquarters loses control over the organization. (See the accompanying Management Focus on Dow Chemical for an example of the problems associated with a matrix structure.)

In light of these problems, many firms that pursue a transnational strategy have tried to build "flexible" matrix structures based more on enterprisewide management knowledge networks, and a shared culture and vision, than on a rigid hierarchical arrangement. Within such companies the informal structure plays a greater role than the formal structure. We discuss this issue when we consider informal integrating mechanisms in the next section.

Accordingly, instead of abandoning its matrix, Dow decided to make it more flexible so it could better accommodate the different businesses, each with its own priorities, within a single management system. A small team of senior executives at headquarters helped set the priorities for each type of business. After priorities were identified for each business sector, one of the three elements of the matrix—function, business, or geographic area—was given primary authority in decision making. Which element took the lead varied according to the type of decision and the market or location in which the company was competing. Such flexibility required that all employees understand what was occurring in the rest of the matrix. Although this may seem confusing, for years Dow claimed this flexible system worked well and credited much of its success to the quality of the decisions it facilitated.

By the mid-1990s, however, Dow had refocused its business on the chemicals industry, divesting itself of its pharmaceutical activities where the company's performance had been unsatisfactory. Reflecting the change in corporate strategy, in 1995 Dow decided to abandon its matrix structure in favor of a more streamlined structure based on global business divisions. The change was also driven by realization that the matrix structure was just too complex and costly to manage in the intense competitive environment of the 1990s, particularly given the company's renewed focus on its commodity chemicals where competitive advantage often went to the low-cost producer. As Dow's then CEO put it in a 1999 interview, "We were an organization that was matrixed and depended on teamwork, but there was no one in charge. When things went well, we didn't know whom to reward; and when things went poorly, we didn't know whom to blame. So we created a global divisional structure, and cut out layers of management. There used to be 11 layers of management between me and the lowest-level employees, now there are five." In short, Dow ultimately found that a matrix structure was unsuited to a company that was competing in very cost-competitive global industries, and it had to abandon its matrix to drive down operating costs.[15]

INTEGRATING MECHANISMS

The previous section explained that firms divide themselves into subunits. One way of coordinating these subunits is through centralization. If the coordination task is complex, however, centralization may not be very effective. Higher-level managers responsible for achieving coordination can soon become overwhelmed by the volume of work required to coordinate the activities of various subunits, particularly if the subunits are large, diverse, and/or geographically dispersed. When this is the case, firms look toward integrating mechanisms, both formal and informal, to help achieve coordination. This section introduces the various integrating mechanisms that international businesses can use. But first, we will explore the need for coordination in international firms and some impediments to coordination.

Strategy and Coordination in the International Business

The need for coordination between subunits varies with the strategy of the firm.[16] The need for coordination is lowest in firms pursuing a localization strategy, is higher in international companies, higher still in global companies, and highest of all in transnational companies. Firms pursuing a localization strategy are primarily concerned with local responsiveness. Such firms are likely to operate with a worldwide area structure in which each area has considerable autonomy and its own set of value creation functions. Because each area is established as a stand-alone entity, the need for coordination between areas is minimized.

The need for coordination is greater in firms pursuing an international strategy and trying to profit from the transfer of core competencies and skills between units at home and abroad. Coordination is necessary to support the transfer of skills and product offerings between units. The need for coordination is also great in firms trying to profit from location and experience curve economies, that is, in firms pursuing global

standardization strategies. Achieving location and experience curve economies involves dispersing value creation activities to various locations around the globe. The resulting global web of activities must be coordinated to ensure the smooth flow of inputs into the value chain, the smooth flow of semifinished products through the value chain, and the smooth flow of finished products to markets around the world.

The need for coordination is greatest in transnational firms, which simultaneously pursue location and experience curve economies, local responsiveness, and the multidirectional transfer of core competencies and skills among all of the firm's subunits (referred to as global learning). As with a global standardization strategy, coordination is required to ensure the smooth flow of products through the global value chain. As with an international strategy, coordination is required for ensuring the transfer of core competencies to subunits. However, the transnational goal of achieving multidirectional transfer of competencies requires much greater coordination than in firms pursuing an international strategy. In addition, a transnational strategy requires coordination between foreign subunits and the firm's globally dispersed value creation activities (e.g., production, R&D, marketing) to ensure that any product offering and marketing strategy is sufficiently customized to local conditions.

Impediments to Coordination

Managers of the various subunits have different orientations, partly because they have different tasks. For example, production managers are typically concerned with production issues such as capacity utilization, cost control, and quality control, whereas marketing managers are concerned with marketing issues such as pricing, promotions, distribution, and market share. These differences can inhibit communication between the managers. Quite simply, these managers often do not even "speak the same language." There may also be a lack of respect between subunits (e.g., marketing managers "looking down on" production managers, and vice versa), which further inhibits the communication required to achieve cooperation and coordination.

Differences in subunits' orientations also arise from their differing goals. For example, worldwide product divisions of a multinational firm may be committed to cost goals that require global production of a standardized product, whereas a foreign subsidiary may be committed to increasing its market share in its country, which will require a nonstandard product. These different goals can lead to conflict.

Such impediments to coordination are not unusual in any firm, but they can be particularly problematic in the multinational enterprise with its profusion of subunits at home and abroad. Differences in subunit orientation are often reinforced in multinationals by the separations of time zone, distance, and nationality between managers of the subunits.

For example, until recently the Dutch company Philips had an organization comprising worldwide product divisions and largely autonomous national organizations. The company has long had problems getting its product divisions and national organizations to cooperate on such things as new-product introductions. When Philips developed a VCR format, the V2000 system, it could not get its North American subsidiary to introduce the product. Rather, the North American unit adopted the rival VHS format produced by Philip's global competitor, Matsushita. Unilever experienced a similar problem in its detergents business. The need to resolve disputes between Unilever's many national organizations and its product divisions extended the time necessary for introducing a new product across Europe to several years (learn more about Unilever in the closing case). This denied Unilever the first-mover advantage crucial to building a strong market position.

Formal Integrating Mechanisms

The formal mechanisms used to integrate subunits vary in complexity from simple direct contact and liaison roles, to teams, to a matrix structure (see Figure 14.9). In general, the greater the need for coordination, the more complex the formal integrating mechanisms need to be.[17]

Direct contact between subunit managers is the simplest integrating mechanism. By this "mechanism," managers of the various subunits simply contact each other whenever they

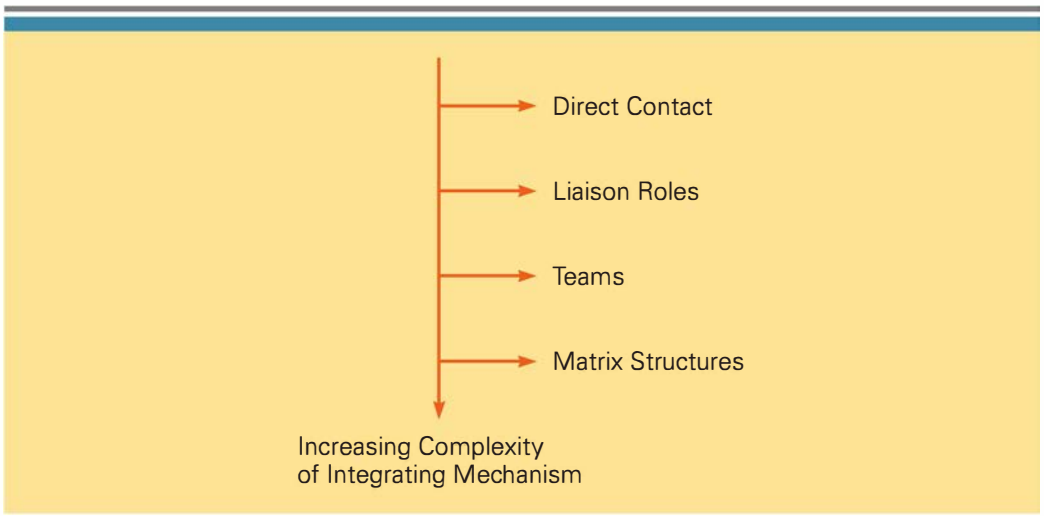


FIGURE 14.9
Formal Integrating Mechanisms

have a common concern. Direct contact may not be effective if the managers have differing orientations that act to impede coordination, as pointed out in the previous subsection.

Liaison roles are a bit more complex. When the volume of contacts between subunits increases, coordination can be improved by giving a person in each subunit responsibility for coordinating with another subunit on a regular basis. Through these roles, the people involved establish a permanent relationship. This helps attenuate the impediments to coordination discussed in the previous subsection.

When the need for coordination is greater still, firms tend to use temporary or permanent teams composed of individuals from the subunits that need to achieve coordination. They typically coordinate product development and introduction, but they are useful when any aspect of operations or strategy requires the cooperation of two or more subunits. Product development and introduction teams are typically composed of personnel from R&D, production, and marketing. The resulting coordination aids the development of products that are tailored to consumer needs and that can be produced at a reasonable cost (design for manufacturing).

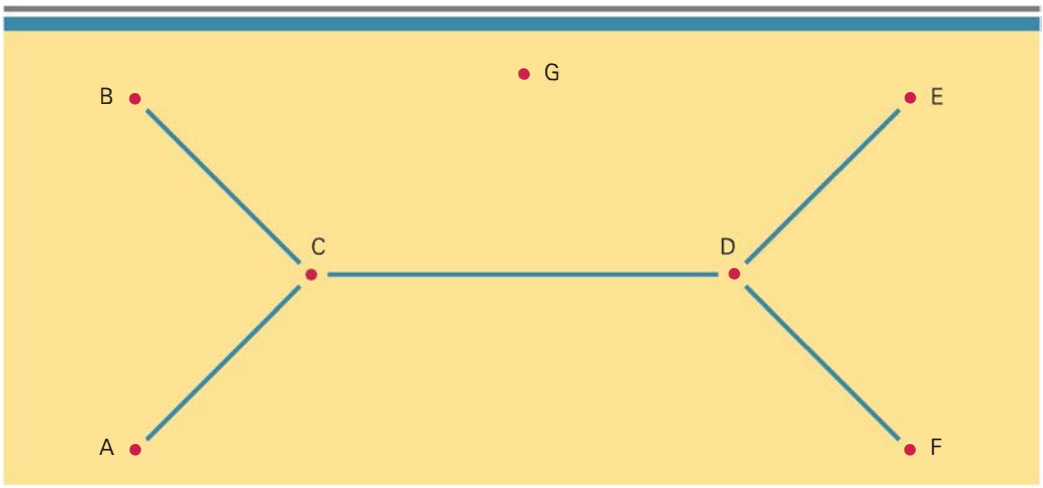
When the need for integration is very high, firms may institute a matrix structure, in which all roles are viewed as integrating roles. The structure is designed to facilitate maximum integration among subunits. The most common matrix in multinational firms is based on geographical areas and worldwide product divisions. This achieves a high level of integration between the product divisions and the areas so that, in theory, the firm can pay close attention to both local responsiveness and the pursuit of location and experience curve economies.

In some multinationals, the matrix is more complex still, structuring the firm into geographical areas, worldwide product divisions, and functions, all of which report directly to headquarters. Thus, within a company such as Dow Chemical before it abandoned its matrix in the mid-1990s (see the Management Focus), each manager belonged to three hierarchies (e.g., a plastics marketing manager in Spain was a member of the Spanish subsidiary, the plastics product division, and the marketing function). In addition to facilitating local responsiveness and location and experience curve economies, such a matrix fosters the transfer of core competencies within the organization. This occurs because core competencies tend to reside in functions (e.g., R&D, marketing). A structure such as this in theory facilitates the transfer of competencies existing in functions from division to division and from area to area.

However, as discussed earlier, such matrix solutions to coordination problems in multinational enterprises can quickly become bogged down in a bureaucratic tangle that creates as many problems as it solves. Matrix structures tend to be bureaucratic, inflexible, and characterized by conflict rather than the hoped-for cooperation. For such a structure to work it needs to be somewhat flexible and to be supported by informal integrating mechanisms.[18]

FIGURE 14.10

A Simple Management Network



Informal Integrating Mechanism: Knowledge Networks

In attempting to alleviate or avoid the problems associated with formal integrating mechanisms in general, and matrix structures in particular, firms with a high need for integration have been experimenting with an informal integrating mechanism: knowledge networks that are supported by an organization culture that values teamwork and cross-unit cooperation.[19] A **knowledge network** is a network for transmitting information within an organization that is based not on formal organization structure, but on informal contacts between managers within an enterprise and on distributed information systems.[20] The great strength of such a network is that it can be used as a nonbureaucratic conduit for knowledge flows within a multinational enterprise.[21] For a network to exist, managers at different locations within the organization must be linked to each other at least indirectly. For example, Figure 14.10 shows the simple network relationships between seven managers within a multinational firm. Managers A, B, and C all know each other personally, as do managers D, E, and F. Although manager B does not know manager F personally, they are linked through common acquaintances (managers C and D). Thus, we can say that managers A through F are all part of the network, and also that manager G is not.

Imagine manager B is a marketing manager in Spain and needs to know the solution to a technical problem to better serve an important European customer. Manager F, an R&D manager in the United States, has the solution to manager B's problem. Manager B mentions her problem to all of her contacts, including manager C, and asks if they know of anyone who might be able to provide a solution. Manager C asks manager D, who tells manager F, who then calls manager B with the solution. In this way, coordination is achieved informally through the network, rather than by formal integrating mechanisms such as teams or a matrix structure.

For such a network to function effectively, however, it must embrace as many managers as possible. For example, if manager G had a problem similar to manager B's, he would not be able to utilize the informal network to find a solution; he would have to resort to more formal mechanisms. Establishing companywide knowledge networks is difficult, and although network enthusiasts speak of networks as the "glue" that binds multinational companies together, it is far from clear how successful firms have been at building companywide networks. Two techniques being used to establish networks are information systems and management development policies.

Firms are using their distributed computer and telecommunications information systems to provide the foundation for informal knowledge networks.[22] Electronic mail, videoconferencing, high-bandwidth data systems, and web-based search engines make it much easier for managers scattered over the globe to get to know each other, to identify contacts that might help to solve a particular problem, and to publicize and share best

practices within the organization. Walmart, for example, now uses its intranet system to communicate ideas about merchandising strategy between stores located in different countries.

Firms are also using their management development programs to build informal networks. Tactics include rotating managers through various subunits on a regular basis so they build their own informal network and using management education programs to bring managers of subunits together in a single location so they can become acquainted.

Knowledge networks by themselves may not be sufficient to achieve coordination if subunit managers persist in pursuing subgoals that are at variance with companywide goals. For a knowledge network to function properly—and for a formal matrix structure to work also—managers must share a strong commitment to the same goals. To appreciate the nature of the problem, consider again the case of manager B and manager F. As before, manager F hears about manager B's problem through the network. However, solving manager B's problem would require manager F to devote considerable time to the task. Insofar as this would divert manager F away from his own regular tasks—and the pursuit of subgoals that differ from those of manager B—he may be unwilling to do it. Thus, manager F may not call manager B, and the informal network would fail to provide a solution to manager B's problem.

To eliminate this flaw, the organization's managers must adhere to a common set of norms and values that override differing subunit orientations.[23] In other words, the firm must have a strong organizational culture that promotes teamwork and cooperation. When this is the case, a manager is willing and able to set aside the interests of his own subunit when doing so benefits the firm as a whole. If manager B and manager F are committed to the same organizational norms and value systems, and if these organizational norms and values place the interests of the firm as a whole above the interests of any individual subunit, manager F should be willing to cooperate with manager B on solving her subunit's problems.

Summary

The message contained in this section is crucial to understanding the problems of managing the multinational firm. Multinationals need integration—particularly if they are pursuing global standardization, international, or transnational strategies—but it can be difficult to achieve due to the impediments to coordination discussed. Firms traditionally have tried to achieve coordination by adopting formal integrating mechanisms. These do not always work, however, since they tend to be bureaucratic and do not necessarily address the problems that arise from differing subunit orientations. This is particularly likely with a complex matrix structure, and yet, a complex matrix structure is required for simultaneously achieving location and experience curve economies, local responsiveness, and the multidirectional transfer of core competencies within the organization. The solution to this dilemma seems twofold. First, the firm must try to establish an informal knowledge network that can do much of the work previously undertaken by a formal matrix structure. Second, the firm must build a common culture. Neither of these partial solutions, however, is easy to achieve.[24]

Control Systems and Incentives

A major task of a firm's leadership is to control the various subunits of the firm—whether they be defined on the basis of function, product division, or geographic area—to ensure their actions are consistent with the firm's overall strategic and financial objectives. Firms achieve this with various control and incentive systems. In this section, we first review the various types of control systems firms use to control their subunits. Then we briefly discuss incentive systems. Then we will look at how the appropriate control and incentive systems vary according to the strategy of the multinational enterprise.

TYPES OF CONTROL SYSTEMS

Four main types of control systems are used in multinational firms: personal controls, bureaucratic controls, output controls, and cultural controls. In most firms, all four are used, but their relative emphasis varies with the strategy of the firm.

Personal Controls

Personal control is control by personal contact with subordinates. This type of control tends to be most widely used in small firms, where it is seen in the direct supervision of subordinates' actions. However, it also structures the relationships between managers at different levels in multinational enterprises. For example, the CEO may use a great deal of personal control to influence the behavior of his or her immediate subordinates, such as the heads of worldwide product divisions or major geographic areas. In turn, these heads may use personal control to influence the behavior of their subordinates, and so on down through the organization. Jack Welch, the longtime CEO of General Electric who retired in 2001, had regular one-on-one meetings with the heads of all of GE's major businesses (most of which are international).[25] He used these meetings to probe the managers about the strategy, structure, and financial performance of their operations. In doing so, he essentially exercised personal control over these managers and, undoubtedly, over the strategies that they favored.

Bureaucratic Controls

Bureaucratic control is control through a system of rules and procedures that directs the actions of subunits. The most important bureaucratic controls in subunits within multinational firms are budgets and capital spending rules. Budgets are essentially a set of rules for allocating a firm's financial resources. A subunit's budget specifies with some precision how much the subunit may spend. Headquarters uses budgets to influence the behavior of subunits. For example, the R&D budget normally specifies how much cash the R&D unit may spend on product development. R&D managers know that if they spend too much on one project, they will have less to spend on other projects, so they modify their behavior to stay within the budget. Most budgets are set by negotiation between headquarters management and subunit management. Headquarters management can encourage the growth of certain subunits and restrict the growth of others by manipulating their budgets.

Capital spending rules require headquarters management to approve any capital expenditure by a subunit that exceeds a certain amount. A budget allows headquarters to specify the amount a subunit can spend in a given year, and capital spending rules give headquarters additional control over how the money is spent. Headquarters can be expected to deny approval for capital spending requests that are at variance with overall firm objectives and to approve those that are congruent with firm objectives.

Output Controls

Output controls involve setting goals for subunits to achieve and expressing those goals in terms of relatively objective performance metrics such as profitability, productivity, growth, market share, and quality. The performance of subunit managers is then judged by their ability to achieve the goals.[26] If goals are met or exceeded, subunit managers will be rewarded. If goals are not met, top management will normally intervene to find out why and take appropriate corrective action. Thus, control is achieved by comparing actual performance against targets and intervening selectively to take corrective action. Subunits' goals depend on their role in the firm. Self-contained product divisions or national subsidiaries are typically given goals for profitability, sales growth, and market share. Functions are more likely to be given goals related to their particular activity. Thus, R&D will be given product development goals, production will be given productivity and quality goals, marketing will be given market share goals, and so on.

As with budgets, goals are normally established through negotiation between subunits and headquarters. Generally, headquarters tries to set goals that are challenging but realistic, so subunit managers are forced to look for ways to improve their operations but are not so pressured that they will resort to dysfunctional activities to do so (such as short-run profit maximization). Output controls foster a system of "management by exception," in that so long as subunits meet their goals, they are left alone. If a subunit fails to attain its goals, however, headquarters managers are likely to ask some tough questions. If they don't get satisfactory answers, they are likely to intervene proactively in a subunit, replacing top management and looking for ways to improve efficiency.

Cultural Controls

Cultural controls exist when employees "buy into" the norms and value systems of the firm. When this occurs, employees tend to control their own behavior, which reduces the need for direct supervision. In a firm with a strong culture, self-control can reduce the need for other control systems. We shall discuss organizational culture later. McDonald's actively promotes organizational norms and values, referring to its franchisees and suppliers as partners and emphasizing its long-term commitment to them. This commitment is not just a public relations exercise; it is backed by actions, including a willingness to help suppliers and franchisees improve their operations by providing capital and/or management assistance when needed. In response, McDonald's franchisees and suppliers are integrated into the firm's culture and thus become committed to helping McDonald's succeed. One result is that McDonald's can devote less time than would otherwise be necessary to controlling its franchisees and suppliers.

INCENTIVE SYSTEMS

Incentives refer to the devices used to reward appropriate employee behavior. Many employees receive incentives in the form of annual bonus pay. Incentives are usually closely tied to the performance metrics used for output controls. For example, setting targets linked to profitability might be used to measure the performance of a subunit, such as a global product division. To create positive incentives for employees to work hard to exceed those targets, they may be given a share of any profits above those targeted. If a subunit has set a goal of attaining a 15 percent return on investment and it actually attains a 20 percent return, unit employees may be given a share in the profits generated in excess of the 15 percent target in the form of bonus pay. We shall return to the topic of incentive systems in Chapter 19 when we discuss human resource strategy in the multinational firm. For now, however, several important points need to be made. First, the type of incentive used often varies depending on the employees and their tasks. Incentives for employees working on the factory floor may be very different from the incentives used for senior managers. The incentives used must be matched to the type of work being performed. The employees on the factory floor of a manufacturing plant may be broken into teams of 20 to 30 individuals, and they may have their bonus pay tied to the ability of their team to hit or exceed targets for output and product quality. In contrast, the senior managers of the plant may be rewarded according to metrics linked to the output of the entire operation. The basic principle is to make sure the incentive scheme for an individual employee is linked to an output target that he or she has some control over and can influence. The individual employees on the factory floor may not be able to exercise much influence over the performance of the entire operation, but they can influence the performance of their team, so incentive pay is tied to output at this level.

Second, the successful execution of strategy in the multinational firm often requires significant cooperation between managers in different subunits. For example, as noted earlier, some multinational firms operate with matrix structures where a country subsidiary might be responsible for marketing and sales in a nation, while a global product division might be responsible for manufacturing and product development. The managers of these different units need to cooperate closely with each other if the firm is to be

successful. One way of encouraging the managers to cooperate is to link incentives to performance at a higher level in the organization. Thus, the senior managers of the country subsidiaries and global product divisions might be rewarded according to the profitability of the entire firm. The thinking here is that boosting the profitability of the entire firm requires managers in the country subsidiaries and product divisions to cooperate with each other on strategy implementation, and linking incentive systems to the next level up in the hierarchy encourages this. Most firms use a formula for incentives that links a portion of incentive pay to the performance of the subunit in which a manager or employee works and a portion to the performance of the entire firm, or some other higher-level organizational unit. The goal is to encourage employees to improve the efficiency of their unit and to cooperate with other units in the organization.

Third, the incentive systems used within a multinational enterprise often have to be adjusted to account for national differences in institutions and culture. Incentive systems that work in the United States might not work, or even be allowed, in other countries. For example, Lincoln Electric, a leader in the manufacture of arc welding equipment, has used an incentive system for its employees based on piecework rates in its American factories (under a piecework system, employees are paid according to the amount they produce). While this system has worked very well in the United States, Lincoln has found that the system is difficult to introduce in other countries. In some countries, such as Germany, piecework systems are illegal, while in others the prevailing national culture is antagonistic to a system where performance is so closely tied to individual effort.

Finally, it is important for managers to recognize that incentive systems can have unintended consequences. Managers need to carefully think through exactly what behavior certain incentives encourage. For example, if employees in a factory are rewarded solely on the basis of how many units of output they produce, with no attention paid to the quality of that output, they may produce as many units as possible to boost their incentive pay, but the quality of those units may be poor.

CONTROL SYSTEMS, INCENTIVES, AND STRATEGY IN THE INTERNATIONAL BUSINESS

The key to understanding the relationship between international strategy, control systems, and incentive systems is the concept of performance ambiguity.

Performance Ambiguity

Performance ambiguity exists when the causes of a subunit's poor performance are not clear. This is not uncommon when a subunit's performance is partly dependent on the performance of other subunits, that is, when there is a high degree of interdependence between subunits within the organization. Consider the case of a French subsidiary of a U.S. firm that depends on another subsidiary, a manufacturer based in Italy, for the products it sells. The French subsidiary is failing to achieve its sales goals, and the U.S. management asks the managers to explain. They reply that they are receiving poor-quality goods from the Italian subsidiary. The U.S. management asks the managers of the Italian operation what the problem is. They reply that their product quality is excellent—the best in the industry, in fact—and that the French simply don't know how to sell a good product. Who is right, the French or the Italians? Without more information, top management cannot tell. Because they are dependent on the Italians for their product, the French have an alibi for poor performance. U.S. management needs to have more information to determine who is correct. Collecting this information is expensive and time consuming and will divert attention away from other issues. In other words, performance ambiguity raises the costs of control.

Consider how different things would be if the French operation were self-contained, with its own manufacturing, marketing, and R&D facilities. The French operation would lack a convenient alibi for its poor performance; the French managers would stand or fall

on their own merits. They could not blame the Italians for their poor sales. The level of performance ambiguity, therefore, is a function of the interdependence of subunits in an organization.

Strategy, Interdependence, and Ambiguity

Now let us consider the relationships between strategy, interdependence, and performance ambiguity. In firms pursuing a localization strategy, each national operation is a stand-alone entity and can be judged on its own merits. The level of performance ambiguity is low. In an international firm, the level of interdependence is somewhat higher. Integration is required to facilitate the transfer of core competencies and skills. Since the success of a foreign operation is partly dependent on the quality of the competency transferred from the home country, performance ambiguity can exist.

In firms pursuing a global standardization strategy, the situation is still more complex. Recall that in a pure global firm the pursuit of location and experience curve economies leads to the development of a global web of value creation activities. Many of the activities in a global firm are interdependent. A French subsidiary's ability to sell a product does depend on how well other operations in other countries perform their value creation activities. Thus, the levels of interdependence and performance ambiguity are high in global companies.

The level of performance ambiguity is highest of all in transnational firms. Transnational firms suffer from the same performance ambiguity problems that global firms do. In addition, since they emphasize the multidirectional transfer of core competencies, they also suffer from the problems characteristic of firms pursuing an international strategy. The extremely high level of integration within transnational firms implies a high degree of joint decision making, and the resulting interdependencies create plenty of alibis for poor performance. There is lots of room for finger-pointing in transnational firms.

Implications for Control and Incentives

The arguments of the previous section, along with the implications for the costs of control, are summarized in Table 14.1. The costs of control can be defined as the amount of time top management must devote to monitoring and evaluating subunits' performance. This is greater when the amount of performance ambiguity is greater. When performance ambiguity is low, management can use output controls and a system of management by exception; when it is high, managers have no such luxury. Output controls do not provide totally unambiguous signals of a subunit's efficiency when the performance of that subunit is dependent on the performance of another subunit within the organization. Thus, management must devote time to resolving the problems that arise from performance ambiguity, with a corresponding rise in the costs of control.

Table 14.1 reveals a paradox. We saw in Chapter 13 that a transnational strategy is desirable because it gives a firm more ways to profit from international expansion than do localization, international, and global standardization strategies. But now we see that due to the high level of interdependence, the costs of controlling transnational firms are higher than the costs of controlling firms that pursue other strategies. Unless there is some way of reducing these costs, the higher profitability associated with a transnational strategy could be canceled out by the higher costs of control. The same point, although

TABLE 14.1

Interdependence, Performance Ambiguity, and the Costs of Control for the Four International Business Strategies

Strategy	Interdependence	Performance Ambiguity	Costs of Control
Localization	Low	Low	Low
International	Moderate	Moderate	Moderate
Global	High	High	High
Transnational	Very High	Very High	Very High

to a lesser extent, can be made with regard to firms pursuing a global standardization strategy. Although firms pursuing a global standardization strategy can reap the cost benefits of location and experience curve economies, they must cope with a higher level of performance ambiguity, and this raises the costs of control (in comparison with firms pursuing an international or localization strategy).

This is where control systems and incentives come in. When we survey the systems that corporations use to control their subunits, we find that irrespective of their strategy, multinational firms all use output and bureaucratic controls. However, in firms pursuing either global or transnational strategies, the usefulness of output controls is limited by substantial performance ambiguities. As a result, these firms place greater emphasis on cultural controls. Cultural control—by encouraging managers to want to assume the organization's norms and value systems—gives managers of interdependent subunits an incentive to look for ways to work out problems that arise between them. The result is a reduction in finger-pointing and, accordingly, in the costs of control. The development of cultural controls may be a precondition for the successful pursuit of a transnational strategy and perhaps of a global strategy as well.[27] As for incentives, the material discussed earlier suggests that the conflict between different subunits can be reduced and the potential for cooperation enhanced if incentive systems are tied in some way to a higher level in the hierarchy. When performance ambiguity makes it difficult to judge the performance of subunits as stand-alone entities, linking the incentive pay of senior managers to the entity to which both subunits belong can reduce the resulting problems.

Processes

Processes, defined as the manner in which decisions are made and work is performed within the organization,[28] can be found at many different levels within an organization. There are processes for formulating strategy, processes for allocating resources, processes for evaluating new-product ideas, processes for handling customer inquiries and complaints, processes for improving product quality, processes for evaluating employee performance, and so on. Often, the core competencies or valuable skills of a firm are embedded in its processes. Efficient and effective processes can lower the costs of value creation and add additional value to a product. For example, the global success of many Japanese manufacturing enterprises in the 1980s was based in part on their early adoption of processes for improving product quality and operating efficiency, including total quality management and just-in-time inventory systems. Today, the competitive success of General Electric can in part be attributed to a number of processes that have been widely promoted within the company. These include the company's Six Sigma process for quality improvement, its process for "digitalization" of business (using corporate intranets and the Internet to automate activities and reduce operating costs), and its process for idea generation, referred to within the company as "workouts," where managers and employees get together for intensive sessions over several days to identify and commit to ideas for improving productivity.

An organization's processes can be summarized by means of a flow chart, which illustrates the various steps and decision points involved in performing work. Many processes cut across functions, or divisions, and require cooperation between individuals in different subunits. For example, product development processes require employees from R&D, manufacturing, and marketing to work together in a cooperative manner to make sure new products are developed with market needs in mind and designed in such a way that they can be manufactured at a low cost. Because they cut across organizational boundaries, performing processes effectively often require the establishment of formal integrating mechanisms and incentives for cross-unit cooperation (see above).

A detailed consideration of the nature of processes and strategies for process improvement and reengineering is beyond the scope of this book. However, it is important to make two basic remarks about managing processes, particularly in the context of an

international business.[29] The first is that in a multinational enterprise, many processes cut not only across organizational boundaries, embracing several different subunits, but also across national boundaries. Designing a new product may require the cooperation of R&D personnel located in California, production people located in Taiwan, and marketing located in Europe, America, and Asia. The chances of pulling this off are greatly enhanced if the processes are embedded in an organizational culture that promotes cooperation between individuals from different subunits and nations, if the incentive systems of the organization explicitly reward such cooperation, and if formal and informal integrating mechanisms are used to facilitate coordination between subunits.

Second, it is particularly important for a multinational enterprise to recognize that valuable new processes that might lead to a competitive advantage can be developed anywhere within the organization's global network of operations.[30] New processes may be developed by a local operating subsidiary in response to conditions pertaining to its market. Those processes might then have value to other parts of the multinational enterprise. For example, in response to competition in Japan and a local obsession with product quality, Japanese firms were at the leading edge of developing processes for total quality management (TQM) in the 1970s. Because few American firms had Japanese subsidiaries at the time, they were relatively ignorant of the trend until the 1980s when high-quality Japanese products began to make big inroads into the United States. An exception to this generalization was Hewlett-Packard, which had a very successful operating company in Japan, Yokogwa Hewlett-Packard (YHP). YHP was a pioneer of the total quality management process in Japan and won the prestigious Deming Prize for its achievements in improving product quality. Through YHP, Hewlett-Packard learned about the quality movement ahead of many of its U.S. peers and was one of the first Western companies to introduce TQM processes into its worldwide operations. Not only did Hewlett-Packard's Japanese operation give the company access to a valuable process, but the company also transferred this knowledge within its global network of operations, raising the performance of the entire company. The ability to create valuable processes matters, but it is also important to leverage those processes. This requires both formal and informal integrating mechanisms such as knowledge networks.

Organizational Culture

Chapter 4 applied the concept of culture to nation-states. Culture, however, is a social construct ascribed to societies, including organizations.[31] Thus, we can speak of organizational culture and organizational subculture. The basic definition of culture remains the same, whether we are applying it to a large society such as a nation-state or a small society such as an organization or one of its subunits. Culture refers to a system of values and norms that are shared among people. Values are abstract ideas about what a group believes to be good, right, and desirable. Norms mean the social rules and guidelines that prescribe appropriate behavior in particular situations. Values and norms express themselves as the behavior patterns or style of an organization that new employees are automatically encouraged to follow by their fellow employees. Although an organization's culture is rarely static, it tends to change relatively slowly.

CREATING AND MAINTAINING ORGANIZATIONAL CULTURE

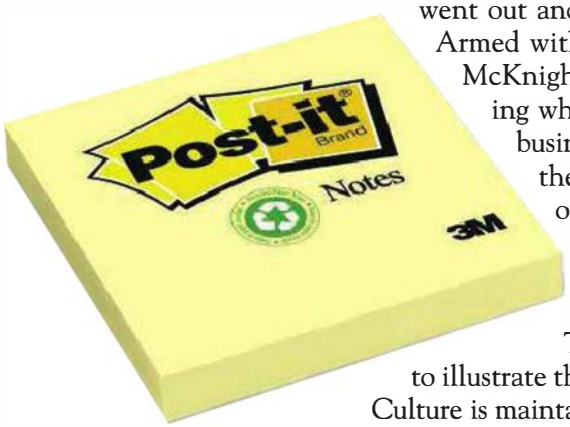
An organization's culture comes from several sources. First, there seems to be wide agreement that founders or important leaders can have a profound impact on an organization's culture, often imprinting their own values on the culture.[32] A famous example of a strong founder effect concerns the Japanese firm Matsushita. Konosuke Matsushita's almost Zen-like personal business philosophy was codified in the "Seven Spiritual Values" of Matsushita that all new employees still learn today. These values are (1) national

service through industry, (2) fairness, (3) harmony and cooperation, (4) struggle for betterment, (5) courtesy and humility, (6) adjustment and assimilation, and (7) gratitude. A leader does not have to be the founder to have a profound influence on organizational culture. Jack Welch is widely credited with having changed the culture of GE, primarily by emphasizing when he first became CEO a countercultural set of values, such as risk taking, entrepreneurship, stewardship, and boundaryless behavior. It is more difficult for a leader, however forceful, to change an established organizational culture than it is to create one from scratch in a new venture.

Another important influence on organizational culture is the broader social culture of the nation where the firm was founded. In the United States, for example, the competitive ethic of individualism looms large and there is enormous social stress on producing winners. Many American firms find ways of rewarding and motivating individuals so that they see themselves as winners.[33] The values of American firms often reflect the values of American culture. Similarly, the cooperative values found in many Japanese firms have been argued to reflect the values of traditional Japanese society, with its emphasis on group cooperation, reciprocal obligations, and harmony.[34] Thus, although it may be a generalization, there may be something to the argument that organizational culture is influenced by national culture.

A third influence on organizational culture is the history of the enterprise, which over time may come to shape the values of the organization. In the language of historians, organizational culture is the path-dependent product of where the organization has been through time. For example, Philips Electronics NV, the Dutch multinational profiled in the opening case, long operated with a culture that placed a high value on the independence of national operating companies. This culture was shaped by the history of the company. During World War II, Holland was occupied by the Germans. With the head office in occupied territories, power was devolved by default to various foreign operating companies, such as Philips subsidiaries in the United States and Great Britain. After the war ended, these subsidiaries continued to operate in a highly autonomous fashion. A belief that this was the right thing to do became a core value of the company.

Decisions that subsequently result in high performance tend to become institutionalized in the values of a firm. In the 1920s, 3M was primarily a manufacturer of sandpaper. Richard Drew, who was a young laboratory assistant at the time, came up with what he thought would be a great new product—a glue-covered strip of paper, which he called "sticky tape." Drew saw applications for the product in the automobile industry, where it could be used to mask parts of a vehicle during painting. He presented the idea to the company's president, William McKnight. An unimpressed McKnight suggested that Drew drop the research. Drew didn't; instead he developed the "sticky tape" and then went out and got endorsements from potential customers in the auto industry. Armed with this information, he approached McKnight again. A chastened McKnight reversed his position and gave Drew the go-ahead to start developing what was to become one of 3M's main product lines—sticky tape—a business it dominates to this day.[35] From then on, McKnight emphasized the importance of giving researchers at 3M free rein to explore their own ideas and experiment with product offerings. This soon became a core value at 3M and was enshrined in the company's famous "15 percent rule," which stated that researchers could spend 15 percent of the company time working on ideas of their own choosing. Today, new employees are often told the Drew story, which is used to illustrate the value of allowing individuals to explore their own ideas.



The Post-it note was an idea that stuck. Innovation continues to be a hallmark of 3M to this day.

Culture is maintained by a variety of mechanisms. These include: (1) hiring and promotional practices of the organization, (2) reward strategies, (3) socialization processes, and (4) communication strategy. The goal is to recruit people whose values are consistent with those of the company. To further reinforce values, a company may promote individuals whose behavior is consistent with the core values of the organization. Merit

review processes may also be linked to a company's values, which further reinforces cultural norms.

Socialization can be formal, such as training programs that educate employees in the core values of the organization. Informal socialization may be friendly advice from peers or bosses or may be implicit in the actions of peers and superiors toward new employees. As for communication strategy, many companies with strong cultures devote a lot of attention to framing their key values in corporate mission statements, communicating them often to employees, and using them to guide difficult decisions. Stories and symbols are often used to reinforce important values (e.g., the Drew and McKnight story at 3M).

ORGANIZATIONAL CULTURE AND PERFORMANCE IN THE INTERNATIONAL BUSINESS

Management authors often talk about "strong cultures."[36] In a strong culture, almost all managers share a relatively consistent set of values and norms that have a clear impact on the way work is performed. New employees adopt these values very quickly, and employees that do not fit in with the core values tend to leave. In such a culture, a new executive is just as likely to be corrected by his subordinates as by his superiors if he violates the values and norms of the organizational culture. Firms with a strong culture are normally seen by outsiders as having a certain style or way of doing things. Lincoln Electric, featured in the accompanying Management Focus, is an example of a firm with a strong culture.

Strong does not necessarily mean good. A culture can be strong but bad. The culture of the Nazi Party in Germany was certainly strong, but it was most definitely not good. Nor does it follow that a strong culture leads to high performance. One study found that in the 1980s General Motors had a "strong culture," but it was a strong culture that discouraged lower-level employees from demonstrating initiative and taking risks, which the authors argued was dysfunctional and led to low performance at GM.[37] Also, a strong culture might be beneficial at one point, leading to high performance, but inappropriate at another time. The appropriateness of the culture depends on the context. In the 1980s, when IBM was performing very well, several management authors sang the praises of its strong culture, which among other things placed a high value on consensus-based decision making.[38] These authors argued that such a decision-making process was appropriate given the substantial financial investments that IBM routinely made in new technology. However, this process turned out to be a weakness in the fast-moving computer industry of the late 1980s and 1990s. Consensus-based decision making was slow, bureaucratic, and not particularly conducive to corporate risk taking. While this was fine in the 1970s, IBM needed rapid decision making and entrepreneurial risk taking in the 1990s, but its culture discouraged such behavior. IBM found itself outflanked by then-small enterprises such as Microsoft.

One academic study concluded that firms that exhibited high performance over a prolonged period tended to have strong but adaptive cultures. According to this study, in an adaptive culture most managers care deeply about and value customers, stockholders, and employees. They also strongly value people and processes that create useful change in a firm.[39] While this is interesting, it does reduce the issue to a very high level of abstraction; after all, what company would say that it doesn't care deeply about customers, stockholders, and employees? A somewhat different perspective is to argue that the culture of the firm must match the rest of the architecture of the organization, the firm's strategy, and the demands of the competitive environment for superior performance to be attained. All these elements must be consistent with each other. Lincoln Electric provides another useful example (see the Management Focus). Lincoln competes in a business that is very competitive, where cost minimization is a key source of competitive advantage. Lincoln's culture and incentive systems both encourage employees to strive for high levels of productivity, which translates into the low costs that are critical for Lincoln's success. The Lincoln example also demonstrates another important point for international businesses: A culture that leads to high performance in the firm's home



MANAGEMENT FOCUS

Culture and Incentives at Lincoln Electric

Lincoln Electric is one of the leading companies in the global market for arc welding equipment. Lincoln's success has been based on extremely high levels of employee productivity. The company attributes its productivity to a strong organizational culture and an incentive scheme based on piecework. Lincoln's organizational culture dates back to James Lincoln, who in 1907 joined the company that his brother had established a few years earlier. Lincoln had a strong respect for the ability of the individual and believed that, correctly motivated, ordinary people could achieve extraordinary performance. He emphasized that Lincoln should be a meritocracy where people were rewarded for their individual effort. Strongly egalitarian, Lincoln removed barriers to communication between "workers" and "managers," practicing an open-door policy. He made sure that all who worked for the company were treated equally; for example, everyone ate in the same cafeteria, there were no reserved parking places for "managers," and so on. Lincoln also believed that any gains in productivity should be shared with consumers in the form of lower prices, with employees in the form of higher pay, and with shareholders in the form of higher dividends.

The organizational culture that grew out of James Lincoln's beliefs was reinforced by the company's incentive system. Production workers receive no base salary but are paid according to the number of pieces they produce. The piecework rates at the company enable an employee working at a normal pace to earn an income equivalent to the average wage for manufacturing workers in the area where a factory is based. Workers have responsibility for the quality of their output and must repair any defects spotted by quality inspectors before the pieces are included in the piecework calculation. Since 1934, production workers have been awarded a semiannual bonus based on merit ratings. These ratings are based on objective criteria (such as an employee's level and quality of output) and subjective criteria (such as an employee's attitudes toward cooperation and his or her dependability). These systems give Lincoln's employees an incentive to work hard and to generate innovations that boost productivity, for doing so influences their level of pay. Lincoln's factory workers have been able to earn a base pay that often exceeds the average manufacturing wage in the area by more than 50 percent and receive a bonus on top of this that in good years could double their base pay. Despite high employee compensation, the workers are so productive that Lincoln has a lower cost structure than its competitors.

While this organizational culture and set of incentives works well in the United States, where it is compatible with the individualistic culture of the country, it did not translate easily into foreign operations. In the 1980s and early 1990s, Lincoln expanded aggressively into Europe and Latin America, acquiring a number of local arc welding manufacturers. Lincoln left local managers in place, believing that they knew local conditions better than Americans. However, the local managers had little working knowledge of Lincoln's strong organizational culture and were unable or unwilling to impose that culture on their units, which had their own long-established organizational cultures. Nevertheless, Lincoln told local managers to introduce its incentive systems in acquired companies. They frequently ran into legal and cultural roadblocks.

In many countries, piecework is viewed as an exploitive compensation system that forces employees to work ever harder. In Germany, where Lincoln made an acquisition, it is illegal. In Brazil, a bonus paid for more than two years becomes a legal entitlement! In many other countries, both managers and workers were opposed to the idea of piecework. Lincoln found that many European workers valued extra leisure more highly than extra income and were not prepared to work as hard as their American counterparts. Many of the acquired companies were also unionized, and the local unions vigorously opposed the introduction of piecework. As a result, Lincoln was not able to replicate the high level of employee productivity that it had achieved in the United States, and its expansion pulled down the performance of the entire company.[40]

nation may not be easy to impose on foreign subsidiaries! Lincoln's culture has clearly helped the firm to achieve superior performance in the U.S. market, but this same culture is very "American" in its form and difficult to implement in other countries. The managers and employees of several of Lincoln's European subsidiaries found the culture to be alien to their own values and were reluctant to adopt it. The result was that Lincoln found it very difficult to replicate in foreign markets the success it has had in the United States. Lincoln compounded the problem by acquiring established enterprises that already had their own organizational culture. Thus, in trying to impose its culture on foreign operating subsidiaries, Lincoln had to deal with two problems: how to change the established organizational culture of those units, and how to introduce an organizational culture whose key values might be alien to the values held by members of that society. These problems are not unique to Lincoln; many international businesses have to deal with exactly the same problems.

The solution Lincoln has adopted is to establish new subsidiaries, rather than acquiring and trying to transform an enterprise with its own culture. It is much easier to establish a set of values in a new enterprise than it is to change the values of an established enterprise. A second solution is to devote a lot of time and attention to transmitting the firm's organizational culture to its foreign operations. This was something Lincoln originally omitted. Other firms make this an important part of their strategy for internationalization. When MTV Networks opens an operation in a new country, it initially staffs that operation with several expatriates. The job of these expatriates is to hire local employees whose values are consistent with the MTV culture and to socialize those individuals into values and norms that underpin MTV's unique way of doing things. Once this has been achieved, the expatriates move on to their next assignment, and local employees run the operation. A third solution is to recognize that it may be necessary to change some aspects of a firm's culture so that it better fits the culture of the host nation. For example, many Japanese firms use symbolic behavior, such as company songs and morning group exercise sessions, to reinforce cooperative values and norms. However, such symbolic behavior is seen as odd in Western cultures, so many Japanese firms have not used such practices in Western subsidiaries.

The need for a common organizational culture that is the same across a multinational's global network of subsidiaries probably varies with the strategy of the firm. Shared norms and values can facilitate coordination and cooperation between individuals from different subunits.[41] A strong common culture may lead to goal congruence and can attenuate the problems that arise from interdependence, performance ambiguities, and conflict among managers from different subsidiaries. As noted earlier, a shared culture may help informal integrating mechanisms such as knowledge networks to operate more effectively. As such, a common culture may be of greater value in a multinational that is pursuing a strategy that requires cooperation and coordination between globally dispersed subsidiaries. This suggests that it is more important to have a common culture in firms employing a transnational strategy than a localization strategy, with global and international strategies falling between these two extremes.

Synthesis: Strategy and Architecture LO3

Chapter 13 identified four basic strategies that multinational firms pursue: localization, international, global, and transnational. So far in this chapter we have looked at several aspects of organization architecture, and we have discussed the interrelationships between these dimensions and strategies. Now it is time to synthesize this material.

LOCALIZATION STRATEGY

Firms pursuing a localization strategy focus on local responsiveness. Table 14.2 shows that such firms tend to operate with worldwide area structures, within which operating decisions are decentralized to functionally self-contained country subsidiaries. The need

Structure and Controls	Strategy			
	Localization	International	Global Standardization	Transnational
Vertical differentiation	Decentralized	Core competency more centralized; rest decentralized	Some centralization	Mixed centralization and decentralization
Horizontal differentiation	Worldwide area structure	Worldwide product divisions	Worldwide product divisions	Informal matrix
Need for coordination	Low	Moderate	High	Very high
Integrating mechanisms	None	Few	Many	Very many
Performance ambiguity	Low	Moderate	High	Very high
Need for cultural controls	Low	Moderate	High	Very high

TABLE 14.2

A Synthesis of Strategy, Structure, and Control Systems

for coordination between subunits (areas and country subsidiaries) is low. This suggests that firms pursuing a localization strategy do not have a high need for integrating mechanisms, either formal or informal, to knit together different national operations. The lack of interdependence implies that the level of performance ambiguity in such enterprises is low, as (by extension) are the costs of control. Thus, headquarters can manage foreign operations by relying primarily on output and bureaucratic controls and a policy of management by exception. Incentives can be linked to performance metrics at the level of country subsidiaries. Since the need for integration and coordination is low, the need for common processes and organization culture is also quite low. Were it not for the fact that these firms are unable to profit from the realization of location and experience curve economies, or from the transfer of core competencies, their organizational simplicity would make this an attractive strategy.

INTERNATIONAL STRATEGY

Firms pursuing an international strategy attempt to create value by transferring core competencies from home to foreign subsidiaries. If they are diverse, as most of them are, these firms operate with a worldwide product division structure. Headquarters typically maintains centralized control over the source of the firm's core competency, which is most typically found in the R&D and/or marketing functions of the firm. All other operating decisions are decentralized within the firm to subsidiary operations in each country (which in diverse firms report to worldwide product divisions).

The need for coordination is moderate in such firms, reflecting the need to transfer core competencies. Thus, although such firms operate with some integrating mechanisms, they are not that extensive. The relatively low level of interdependence that results translates into a relatively low level of performance ambiguity. These firms can generally get by with output and bureaucratic controls and with incentives that are focused on performance metrics at the level of country subsidiaries. The need for a common organizational culture and common processes is not that great. An important exception to this is when the core skills or competencies of the firm are embedded in processes and culture, in which case the firm needs to pay close attention to transferring

those processes and associated culture from the corporate center to country subsidiaries. Overall, although the organization required for an international strategy is more complex than that of firms pursuing a localization strategy, the increase in the level of complexity is not that great.

GLOBAL STANDARDIZATION STRATEGY

Firms pursuing a global standardization strategy focus on the realization of location and experience curve economies. If they are diversified, as many of them are, these firms operate with a worldwide product division structure. To coordinate the firm's globally dispersed web of value creation activities, headquarters typically maintains ultimate control over most operating decisions. In general, such firms are more centralized than enterprises pursuing a localization or international strategy. Reflecting the need for coordination of the various stages of the firms' globally dispersed value chains, the need for integration in these firms also is high. Thus, these firms tend to operate with an array of formal and informal integrating mechanisms. The resulting interdependencies can lead to significant performance ambiguities. As a result, in addition to output and bureaucratic controls, firms pursuing a global standardization strategy tend to stress the need to build a strong organizational culture that can facilitate coordination and cooperation. They also tend to use incentive systems that are linked to performance metrics at the corporate level, giving the managers of different operations a strong incentive to cooperate with each other to increase the performance of the entire corporation. On average, the organization of such firms is more complex than that of firms pursuing a localization or international strategy.

TRANSNATIONAL STRATEGY

Firms pursuing a transnational strategy focus on the simultaneous attainment of location and experience curve economies, local responsiveness, and global learning (the multidirectional transfer of core competencies or skills). These firms may operate with matrix-type structures in which both product divisions and geographic areas have significant influence. The need to coordinate a globally dispersed value chain and to transfer core competencies creates pressures for centralizing some operating decisions (particularly production and R&D). At the same time, the need to be locally responsive creates pressures for decentralizing other operating decisions to national operations (particularly marketing). Consequently, these firms tend to mix relatively high degrees of centralization for some operating decisions with relative high degrees of decentralization for other operating decisions.

The need for coordination is high in transnational firms. This is reflected in the use of an array of formal and informal integrating mechanisms, including formal matrix structures and informal management networks. The high level of interdependence of subunits implied by such integration can result in significant performance ambiguities, which raise the costs of control. To reduce these, in addition to output and bureaucratic controls, firms pursuing a transnational strategy need to cultivate a strong culture and to establish incentives that promote cooperation between subunits.

ENVIRONMENT, STRATEGY, ARCHITECTURE, AND PERFORMANCE

Underlying the scheme outlined in Table 14.2 is the notion that a "fit" between strategy and architecture is necessary for a firm to achieve high performance. For a firm to succeed, two conditions must be fulfilled. First, the firm's strategy must be consistent with the environment in which the firm operates. We discussed this issue in Chapter 13 and noted that in some industries a global standardization strategy is most viable, in others an international or transnational strategy may be most viable, and in still others a

localization strategy may be most viable. Second, the firm's organization architecture must be consistent with its strategy.

If the strategy does not fit the environment, the firm is likely to experience significant performance problems. If the architecture does not fit the strategy, the firm is also likely to experience performance problems. Therefore, to survive, a firm must strive to achieve a fit of its environment, its strategy, and its organizational architecture. You will recall that we saw the importance of this concept in the opening case. For reasons rooted in the history of the firm, Philips operated until recently with an organization typical of an enterprise pursuing localization; operating decisions were decentralized to largely autonomous foreign subsidiaries. Historically, electronics markets were segmented from each other by high trade barriers, so an organization consistent with a localization strategy made sense. However, by the mid-1980s, the industry in which Philips competed had been revolutionized by declining trade barriers, technological change, and the emergence of low-cost Japanese competitors that utilized a global strategy. To survive, Philips needed to adopt a global standardization strategy itself. The firm recognized this and tried to adopt a global posture, but it did little to change its organizational architecture. The firm nominally adopted a matrix structure based on worldwide product divisions and national areas. In reality, however, the national areas continued to dominate the organization, and the product divisions had little more than an advisory role. As a result, Philips' architecture did not fit the strategy, and by the early 1990s Philips was losing money. It was only after four years of wrenching change and large losses that Philips was finally able to tilt the balance of power in its matrix toward the product divisions. By the mid-1990s, the fruits of this effort to realign the company's strategy and architecture with the demands of its operating environment were beginning to show up in improved financial performance.[42]

LO4 Organizational Change

Multinational firms periodically have to alter their architecture so that it conforms to the changes in the environment in which they are competing and the strategy they are pursuing. To be profitable, Philips NV had to alter its strategy and architecture in the 1990s so that both matched the demands of the competitive environment in the electronics industry, which had shifted from localization and toward a global industry. While a detailed consideration of organizational change is beyond the scope of this book, a few comments are warranted regarding the sources of organization inertia and the strategies and tactics for implementing organizational change.

ORGANIZATIONAL INERTIA

Organizations are difficult to change. Within most organizations are strong inertia forces. These forces come from a number of sources. One source of inertia is the existing distribution of power and influence within an organization.[43] The power and influence enjoyed by individual managers is in part a function of their role in the organizational hierarchy, as defined by structural position. By definition, most substantive changes in an organization require a change in structure and, by extension, a change in the distribution of power and influence within the organization. Some individuals will see their power and influence increase as a result of organizational change, and some will see the converse. For example, in the 1990s, Philips increased the roles and responsibilities of its global product divisions and decreased the roles and responsibilities of its foreign subsidiary companies. This meant the managers running the global product divisions saw their power and influence increase, while the managers running the foreign subsidiary companies saw their power and influence

decline. As might be expected, some managers of foreign subsidiary companies did not like this change and resisted it, which slowed the pace of change. Those whose power and influence are reduced as a consequence of organizational change can be expected to resist it, primarily by arguing that the change might not work. To the extent that they are successful, this constitutes a source of organizational inertia that might slow or stop change.

Another source of organizational inertia is the existing culture, as expressed in norms and value systems. Value systems reflect deeply held beliefs, and as such, they can be very hard to change. If the formal and informal socialization mechanisms within an organization have been emphasizing a consistent set of values for a prolonged period, and if hiring, promotion, and incentive systems have all reinforced these values, then suddenly announcing that those values are no longer appropriate and need to be changed can produce resistance and dissonance among employees. For example, Philips historically placed a very high value on local autonomy. The changes of the 1990s implied a reduction in the autonomy enjoyed by foreign subsidiaries, which was counter to the established values of the company and thus resisted.

Organizational inertia might also derive from senior managers' preconceptions about the appropriate business model or paradigm. When a given paradigm has worked well in the past, managers might have trouble accepting that it is no longer appropriate. At Philips, granting considerable autonomy to foreign subsidiaries had worked very well in the past, allowing local managers to tailor product and business strategy to the conditions prevailing in a given country. Since this paradigm had worked so well, it was difficult for many managers to understand why it no longer applied. Consequently, they had difficulty accepting a new business model and tended to fall back on their established paradigm and ways of doing things. This change required managers to let go of long-held assumptions about what worked and what didn't work, which was something many of them couldn't do.

Institutional constraints might also act as a source of inertia. National regulations including local content rules and policies pertaining to layoffs might make it difficult for a multinational to alter its global value chain. A multinational might wish to take control for manufacturing away from local subsidiaries, transfer that control to global product divisions, and consolidate manufacturing at a few choice locations. However, if local content rules (see Chapter 6) require some degree of local production and if regulations regarding layoffs make it difficult or expensive for a multinational to close operations in a country, a multinational may find that these constraints make it very difficult to adopt the most effective strategy and architecture.

IMPLEMENTING ORGANIZATIONAL CHANGE

Although all organizations suffer from inertia, the complexity and global spread of many multinationals might make it particularly difficult for them to change their strategy and architecture to match new organizational realities. Yet at the same time, the trend toward globalization in many industries has made it more critical than ever that many multinationals do just that. In industry after industry, declining barriers to cross-border trade and investment have led to a change in the nature of the competitive environment. Cost pressures have increased, requiring multinationals to respond by streamlining their operations to realize economic benefits associated with location and experience curve economies and with the transfer of competencies and skills within the organization. At the same time, local responsiveness remains an important source of differentiation. To survive in this emerging competitive environment, multinationals must change not only their strategy but also their architecture so that it matches strategy in discriminating ways. The basic principles for successful organizational change can be summarized as follows: (1) unfreeze the organization through shock therapy, (2) move the organization

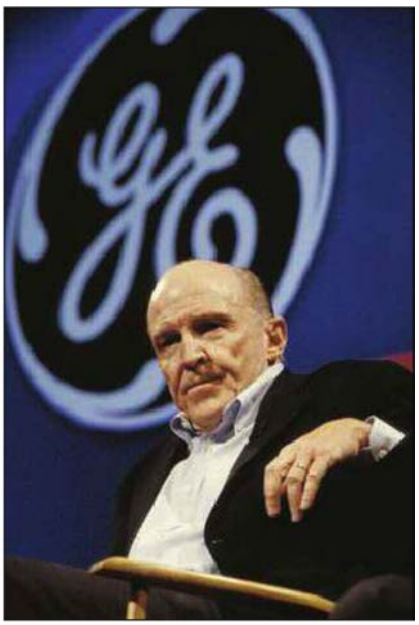
to a new state through proactive change in the architecture, and (3) refreeze the organization in its new state.

Unfreezing the Organization

Because of inertia forces, incremental change is often no change. Those whose power is threatened by change can too easily resist incremental change. This leads to the big bang theory of change, which maintains that effective change requires taking bold action early to "unfreeze" the established culture of an organization and to change the distribution of power and influence. Shock therapy to unfreeze the organization might include the closure of plants deemed uneconomic or the announcement of a dramatic structural reorganization. It is also important to realize that change will not occur unless senior managers are committed to it. Senior managers must clearly articulate the need for change so employees understand both why it is being pursued and the benefits that will flow from successful change. Senior managers must also practice what they preach and take the necessary bold steps. If employees see senior managers preaching the need for change but not changing their own behavior or making substantive changes in the organization, they will soon lose faith in the change effort, which then will flounder.

Moving to the New State

Once an organization has been unfrozen, it must be moved to its new state. Movement requires taking action—closing operations; reorganizing the structure; reassigning responsibilities; changing control, incentive, and reward systems; redesigning processes; and letting people go who are seen as an impediment to change. In other words, movement requires a substantial change in the form of a multinational's organization architecture so that it matches the desired new strategic posture. For movement to be successful, it must be done with sufficient speed. Involving employees in the change effort is an excellent way to get them to appreciate and buy into the needs for change and to help with rapid movement. For example, a firm might delegate substantial responsibility for designing operating processes to lower-level employees. If enough of their recommendations are then acted on, the employees will see the consequences of their efforts and consequently buy into the notion that change is really occurring.



Jack Welch, General Electric's legendary former CEO, set a benchmark for embracing change.

Refreezing the Organization

Refreezing the organization takes longer. It may require that a new culture be established, while the old one is being dismantled. Thus, refreezing requires that employees be socialized into the new way of doing things. Companies will often use management education programs to achieve this. At General Electric, where longtime CEO Jack Welch instituted a major change in the culture of the company, management education programs were used as a proactive tool to communicate new values to organization members. On their own, however, management education programs are not enough. Hiring policies must be changed to reflect the new realities, with an emphasis on hiring individuals whose own values are consistent with that of the new culture the firm is trying to build. Similarly, control and incentive systems must be consistent with the new realities of the organization, or change will never take. Senior management must recognize that changing culture takes a long time. Any letup in the pressure to change may allow the old culture to reemerge as employees fall back into familiar ways of doing things. The communication task facing senior managers, therefore, is a long-term endeavor that requires managers to be relentless and persistent in their pursuit of change. One striking feature of Jack Welch's two-decade tenure at GE, for example, is that he never stopped pushing his change agenda. It was a consistent theme of his tenure. He was always thinking up new programs and initiatives to keep pushing the culture of the organization along the desired trajectory.

CHAPTER SUMMARY

This chapter identified the organizational architecture that can be used by multinational enterprises to manage and direct their global operations. A central theme of the chapter was that different strategies require different architectures; strategy is implemented through architecture. To succeed, a firm must match its architecture to its strategy in discriminating ways. Firms whose architecture does not fit their strategic requirements will experience performance problems. It is also necessary for the different components of architecture to be consistent with each other. The chapter made the following points:

1. Organizational architecture refers to the totality of a firm's organization, including formal organizational structure, control systems and incentives, processes, organizational culture, and people.
2. Superior enterprise profitability requires three conditions to be fulfilled: the different elements of a firm's organizational architecture must be internally consistent, the organizational architecture must fit the strategy of the firm, and the strategy and architecture of the firm must be consistent with competitive conditions prevailing in the firm's markets.
3. Organizational structure means three things: the formal division of the organization into subunits (horizontal differentiation), the location of decision-making responsibilities within that structure (vertical differentiation), and the establishment of integrating mechanisms.
4. Control systems are the metrics used to measure the performance of subunits and make judgments about how well managers are running those subunits.
5. Incentives refer to the devices used to reward appropriate employee behavior. Many employees receive incentives in the form of annual bonus pay. Incentives are usually closely tied to the performance metrics used for output controls.
6. Processes refer to the manner in which decisions are made and work is performed within the organization. Processes can be found at many different levels within an organization. The core competencies or valuable skills of a firm are often embedded in its processes. Efficient and effective processes can help to lower the costs of value creation and to add additional value to a product.
7. Organizational culture refers to a system of values and norms that is shared among employees. Values and norms express themselves as the behavior patterns or style of an organization that new employees are automatically encouraged to follow by their fellow employees.
8. Firms pursuing different strategies must adopt a different architecture to implement those strategies successfully. Firms pursuing localization, global, international, and transnational strategies all must adopt an organizational architecture that matches their strategy.
9. While all organizations suffer from inertia, the complexity and global spread of many multinationals might make it particularly difficult for them to change their strategy and architecture to match new organizational realities. At the same time, the trend toward globalization in many industries has made it more critical than ever that many multinationals do just that.

Critical Thinking and Discussion Questions

1. "The choice of strategy for a multinational firm must depend on a comparison of the benefits of that strategy (in terms of value creation) with the costs of implementing it (as defined by organizational architecture necessary for implementation). On this basis, it may be logical for some firms to pursue a localization strategy, others a global or international strategy, and still others a transnational strategy." Is this statement correct?
2. Discuss this statement: "An understanding of the causes and consequences of performance ambiguity is central to the issue of organizational design in multinational firms."
3. Describe the organizational architecture a transnational firm might adopt to reduce the costs of control.
4. What is the most appropriate organizational architecture for a firm that is competing in an industry where a global strategy is most appropriate?

5. If a firm is changing its strategy from an international to a transnational strategy, what are the most important challenges it is likely to face in implementing this change? How can the firm overcome these challenges?
6. Reread the Management Focus on Walmart's international division and answer the following questions:
   a. Why did the centralization of decisions at the headquarters on Walmart's international division create problems for the company's different national operations? Has Walmart's response been appropriate?
   b. Do you think that having an international division is the best structure for managing Walmart's foreign operations? What problems might arise with this structure? What other structure might work?
7. Reread the Management Focus on the rise and fall of the matrix structure at Dow Chemical, then answer the following questions:
   a. Why did Dow first adopt a matrix structure? What were the problems with this structure? Do you think these problems are typical of matrix structures?
   b. What drove the shift away from the matrix structure in the late 1990s? Does Dow's structure now make sense given the nature of its businesses and the competitive environment it competes in?
8. Reread the Management Focus on Lincoln Electric, then answer the following questions:
   a. To what extent are the organization culture and incentive systems of Lincoln Electric aligned with the firm's strategy?
   b. How was the culture at Lincoln Electric created and nurtured over time?
   c. Why did the culture and incentive systems work well in the United States? Why did it not take in other nations?

Research Task globalEDGE globaledge.msu.edu

The Organization of International Business

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

Fortune conducts an annual survey and publishes the rankings of its "Most Admired Companies" in the world. Locate the most recent ranking available and focus on the methodology used to determine which companies are most admired. Prepare an executive summary of the strategic and organizational success factors involved in this survey.

Exercise 2

Globalization can present many challenges and opportunities for companies, cultures, and countries. In fact, the globalEDGE website features a blog that includes current discussions on globalization. Locate the globalEDGE Blog and find a recent blog post that provides insights concerning the challenges and opportunities of globalization facing firms from an emerging or developing economy. Prepare a description of the issue and provide an examination of these challenges and opportunities on regional and global firm operations for firms from your chosen economy.

CLOSING CASE

A Decade of Organizational Change at Unilever

Unilever is one of the world's oldest multinational corporations with extensive product offerings in the food, detergent, and personal care businesses. It generates annual revenues in excess of $50 billion and a wide range of branded products in virtually every country. Detergents, which account for about 25 percent of corporate revenues,

include well-known names such as Omo, which is sold in more than 50 countries. Personal care products, which account for about 15 percent of sales, include Calvin Klein Cosmetics, Pepsodent toothpaste brands, Faberge hair care products, and Vaseline skin lotions. Food products account for the remaining 60 percent of sales and include strong offerings in margarine (where Unilever's market share in most countries exceeds 70 percent), tea, ice cream, frozen foods, and bakery products.

Historically, Unilever was organized on a decentralized basis. Subsidiary companies in each major national market were responsible for the production, marketing, sales, and distribution of products in that market. In Western Europe, for example, the company had 17 subsidiaries in the early 1990s, each focused on a different national market. Each was a profit center and each was held accountable for its own performance. This decentralization was viewed as a source of strength. The structure allowed local managers to match product offerings and marketing strategy to local tastes and preferences and to alter sales and distribution strategies to fit the prevailing retail systems. To drive the localization, Unilever recruited local managers to run local organizations; the U.S. subsidiary (Lever Brothers) was run by Americans, the Indian subsidiary by Indians, and so on.

By the mid-1990s, this decentralized structure was increasingly out of step with a rapidly changing competitive environment. Unilever's global competitors, which include the Swiss firm Nestlé and Procter & Gamble from the United States, had been more successful than Unilever on several fronts—building global brands, reducing cost structure by consolidating manufacturing operations at a few choice locations, and executing simultaneous product launches in several national markets. Unilever's decentralized structure worked against efforts to build global or regional brands. It also meant lots of duplication, particularly in manufacturing; a lack of scale economies; and a high-cost structure. Unilever also found that it was falling behind rivals in the race to bring new products to market. In Europe, for example, while Nestlé and Procter & Gamble moved toward pan-European product launches, it could take Unilever four to five years to "persuade" its 17 European operations to adopt a new product.

Unilever began to change all this in the mid-1990s. In 1996, it introduced a new structure based on regional business groups. Within each business group were a number of divisions, each focusing on a specific category of products. Thus, in the European Business Group, a division focused on detergents, another on ice cream and frozen foods, and so on. These groups and divisions coordinated the activities of national subsidiaries within their region to drive down operating costs and speed up the process of developing and introducing new products.

For example, Lever Europe was established to consolidate the company's detergent operations. The 17 European companies reported directly to Lever Europe. Using its newfound organizational clout, Lever Europe consolidated the production of detergents in Europe in a few key locations to reduce costs and speed up new-product introduction. Implicit in this new approach was a bargain: the 17 companies relinquished autonomy in their traditional markets in exchange for opportunities to help develop and execute a unified pan-European strategy. The number of European plants manufacturing soap was cut from 10 to 2, and some new products were manufactured at only one site. Product sizing and packaging were harmonized to cut purchasing costs and to accommodate unified pan-European advertising. By taking these steps, Unilever estimated it saved as much as $400 million a year in its European detergent operations.

By 2000, however, Unilever found that it was still lagging its competitors, so the company embarked upon another reorganization. This time the goal was to cut the number of brands that Unilever sold from 1,600 to just 400 that could be marketed on a regional or global scale. To support this new focus, the company planned to reduce the number of manufacturing plants from 380 to about 280 by 2004. The company also established a new organization based on just two global product divisions—a food division and a home and personal care division. Within each division are a number of regional business groups that focus on developing, manufacturing, and marketing either food or personal care products within a given region. For example, Unilever Bestfoods Europe, which is headquartered in Rotterdam, focuses on selling food brands across Western and Eastern Europe, while Unilever Home and Personal Care Europe does the same for home and personal care products. A similar structure can be found in North America, Latin America, and Asia. Thus, Bestfoods North America, headquartered in New Jersey, has a similar charter to Bestfoods Europe, but in keeping with differences in local history, many of the food brands marketed by Unilever in North America are different from those marketed in Europe.[44]

Case Discussion Questions

1. Why did Unilever's decentralized structure make sense in the 1950s and 1970s? Why did this structure start to create problems for the company in the 1980s?
2. What was Unilever trying to do when it introduced a new structure based on business groups in the mid-1990s? Why do you think that this structure failed to cure Unilever's ills?
3. In the 2000s Unilever switched to a structure based on global product divisions? What do you think is the underlying logic for this shift? Does the structure make sense given the nature of competition in the detergents and food business?

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15 Entry Strategy and Strategic Alliances

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Explain the three basic decisions that firms contemplating foreign expansion must make: which markets to enter, when to enter those markets, and on what scale.
- **LO2** Compare and contrast the different modes that firms use to enter foreign markets.
- **LO3** Identify the factors that influence a firm's choice of entry mode.
- **LO4** Recognize the pros and cons of acquisitions versus greenfield ventures as an entry strategy.
- **LO5** Evaluate the pros and cons of entering into strategic alliances.

General Motors in China

The late 2000s were not kind to General Motors. Hurt by a deep recession in the United States and plunging vehicle sales, GM capped off a decade where it had progressively lost market share to foreign rivals such as Toyota by entering Chapter11 bankruptcy. Between 1980, when it dominated the U.S. market, and 2009, when it entered bankruptcy protection, GM saw its U.S. market share slip from 44 percent to just 19 percent. The troubled company emerged from bankruptcy a few months later a smaller enterprise with fewer brands, and yet going forward some believe that the new GM could be a much more profitable enterprise. One major reason for this optimism was the success of its joint ventures in China.

GM entered China in 1997 with a $1.6 billion investment to establish a joint venture with the state-owned Shanghai Automotive Industry Corp. (SAIC) to build Buick sedans. At the time the Chinese market was tiny (fewer than 400,000 cars were sold in 1996), but GM was attracted by the enormous potential in a country of more than 1 billion people that was experiencing rapid economic growth. GM forecast that by the late 2000s some 3 million cars a year might be sold in China. While it explicitly recognized that it had much to learn about the Chinese market, and would probably lose money for years to come, GM executives believed it was crucial to establish a beachhead and to team up with SAIC (one of the early leaders in China's emerging automobile industry) before its global rivals did. The decision to enter a joint venture was not a hard one. Not only did GM lack knowledge and connections in China, but also Chinese government regulations made it all but impossible for a foreign automaker to go it alone in the country.

While GM was not alone in investing in China—many of the world's major automobile companies entered into some kind of Chinese joint venture during this time period—it was among the largest investors. Only Volkswagen, whose management shared GM's view, made similar-size investments. Other companies adopted a more cautious approach, investing smaller amounts and setting more limited goals.



By 2007 GM had expanded the range of its partnership with SAIC to include vehicles sold under the names of Chevrolet, Cadillac, and Wuling. The two companies had also established the Pan-Asian Technical Automotive center to design cars and components not just for China, but also for other Asian markets. At this point it was already clear that both the Chinese market and the joint venture were exceeding GM's initial expectations. Not only was the venture profitable, but it was also selling more than 900,000 cars and light trucks in 2007, an 18 percent increase over 2006 and placing it second only to Volkswagen in the market among foreign nameplates. Equally impressive, some 8 million cars and light trucks were sold in China in 2007, making China the second-largest car market in the world, ahead of Japan and behind the United States.

Much of the venture's success could be attributed to its strategy of designing vehicles explicitly for the Chinese market. For example, together with SAIC it produced a tiny minivan, the Wuling Sunshine. The van costs $3,700, has a 0.8-liter engine, hits a top speed of 60 mph, and weighs less than 1000 kg—a far cry from the heavy SUVs GM was known for in the United States. For China, the vehicle was perfect, and some 460,000 were sold in 2007, making it the best seller in the light truck sector.

It is the future, however, that has people excited. In 2008 and 2009, while the U.S. and European automobile markets slumped, China's market registered strong growth. In 2009 some 13.8 million vehicles were sold in the country, surpassing the United States to become the largest automobile market in the world, and in 2010 the figure was close to 18 million. GM and its local partners sold 1.8 million vehicles in 2008, which was a record and represented a 67 percent increase over 2007. At this point, there were 40 cars for every 1,000 people in China, compared to 765 for every 1,000 in the United States, suggesting China could see rapid growth for years to come. In 2010 GM sold 2.35 million cars in China, more than the 2.22 million it sold in the United States![1]

Introduction

This chapter is concerned with three closely related topics: (1) the decision of which foreign markets to enter, when to enter them, and on what scale; (2) the choice of entry mode; and (3) the role of strategic alliances. Any firm contemplating foreign expansion must first struggle with the issue of which foreign markets to enter and the timing and scale of entry. The choice of which markets to enter should be driven by an assessment of relative long-run growth and profit potential. For example, as discussed in the opening case, General Motors was an early entrant into China's automobile market and entered on a significant scale. Its commitment to this market was driven by a belief that China would ultimately emerge as one of the largest automobile markets in the world and that consequently, it was important to establish an early lead. By 2010 GM's vision had come to pass. China was *the* largest automobile market in the world, and GM was a dominant player in the market.

The choice of mode for entering a foreign market is another major issue with which international businesses must wrestle. The various modes for serving foreign markets are exporting, licensing or franchising to host-country firms, establishing joint ventures with a host-country firm, setting up a new wholly owned subsidiary in a host country to serve its market, and acquiring an established enterprise in the host nation to serve that market. Each of these options has advantages and disadvantages. The magnitude of the advantages and disadvantages associated with each entry mode is determined by a number of factors, including transport costs, trade barriers, political risks, economic risks, business risks, costs, and firm strategy. The optimal entry mode varies by situation, depending on these factors. Thus, whereas some firms may best serve a given market by exporting, other firms may better serve the market by setting up a new wholly owned subsidiary or by acquiring an established enterprise. In the case of GM in China, its choice of entry mode, a joint venture with Shanghai Automotive Industry Corp., was dictated by circumstances at the time (Chinese government regulations made a joint venture the only practical alternative).

The final topic of this chapter is strategic alliances. **Strategic alliances** are cooperative agreements between potential or actual competitors. The term is often used to embrace a variety of agreements between actual or potential competitors including cross-shareholding deals, licensing arrangements, formal joint ventures, and informal cooperative arrangements. The motives for entering strategic alliances are varied, but they often include market access, hence the overlap with the topic of entry mode.

LO1 Basic Entry Decisions

A firm contemplating foreign expansion must make three basic decisions: which markets to enter, when to enter those markets, and on what scale.[2]

WHICH FOREIGN MARKETS?

The more than 200 nation-states in the world do not all hold the same profit potential for a firm contemplating foreign expansion. Ultimately, the choice must be based on an assessment of a nation's long-run profit potential. This potential is a function of several factors, many of which we have studied in earlier chapters. Chapters 2 and 3 looked in detail at the economic and political factors that influence the potential attractiveness of a foreign market. The attractiveness of a country as a potential market for an international business depends on balancing the benefits, costs, and risks associated with doing business in that country.

Chapters 2 and 3 also noted that the long-run economic benefits of doing business in a country are a function of factors such as the size of the market (in terms of demographics), the present wealth (purchasing power) of consumers in that market, and the likely future wealth of consumers, which depends upon economic growth rates. While some markets

are very large when measured by number of consumers (e.g., China, India, and Indonesia), one must also look at living standards and economic growth. On this basis, China and India, while relatively poor, are growing so rapidly that they are attractive targets for inward investment (hence GM's decision to invest in China in 1997; see the opening case). Alternatively, weak growth in Indonesia implies that this populous nation is a far less attractive target for inward investment. As we saw in Chapters 2 and 3, likely future economic growth rates appear to be a function of a free market system and a country's capacity for growth (which may be greater in less developed nations). Also, the costs and risks associated with doing business in a foreign country are typically lower in economically advanced and politically stable democratic nations, and they are greater in less developed and politically unstable nations.

The discussion in Chapters 2 and 3 suggests that, other things being equal, the benefit–cost–risk trade-off is likely to be most favorable in politically stable developed and developing nations that have free market systems, and where there is not a dramatic upsurge in either inflation rates or private-sector debt. The trade-off is likely to be least favorable in politically unstable developing nations that operate with a mixed or command economy or in developing nations where speculative financial bubbles have led to excess borrowing.

Another important factor is the value an international business can create in a foreign market. This depends on the suitability of its product offering to that market and the nature of indigenous competition.[3] If the international business can offer a product that has not been widely available in that market and that satisfies an unmet need, the value of that product to consumers is likely to be much greater than if the international business simply offers the same type of product that indigenous competitors and other foreign entrants are already offering. Greater value translates into an ability to charge higher prices and/or to build sales volume more rapidly. By considering such factors, a firm can rank countries in terms of their attractiveness and long-run profit potential. Preference is then given to entering markets that rank highly. For example, Tesco, the large British grocery chain, has been aggressively expanding its foreign operations in recent years, primarily by focusing on emerging markets that lack strong indigenous competitors (see the accompanying Management Focus). Similarly, when GM entered China in 1997, the indigenous competitors were small and lacked technological know-how (see opening case).

TIMING OF ENTRY

Once attractive markets have been identified, it is important to consider the **timing of entry**. Entry is early when an international business enters a foreign market before other foreign firms and late when it enters after other international businesses have already established themselves. The advantages frequently associated with entering a market early are commonly known as **first-mover advantages**.[4] One first-mover advantage is the ability to preempt rivals and capture demand by establishing a strong brand name. This desire has driven the rapid expansion by Tesco into developing nations (see the Management Focus). A second advantage is the ability to build sales volume in that country and ride down the experience curve ahead of rivals, giving the early entrant a cost advantage over later entrants. One could argue that this factor motivated GM to enter the Chinese automobile market in 1997 when it was still tiny (it is now the world's largest; see the opening case). This cost advantage may enable the early entrant to cut prices below that of later entrants, thereby driving them out of the market. A third advantage is the ability of early entrants to create switching costs that tie customers into their products or services. Such switching costs make it difficult for later entrants to win business.

There can also be disadvantages associated with entering a foreign market before other international businesses. These are often referred to as **first-mover disadvantages**.[5] These disadvantages may give rise to **pioneering costs**, costs that an early entrant has to bear that a later entrant can avoid. Pioneering costs arise when the business system in a foreign country is so different from that in a firm's home market that the enterprise has



MANAGEMENT FOCUS

Tesco's International Growth Strategy

Tesco is the largest grocery retailer in the United Kingdom, with a 25 percent share of the local market. In its home market, the company's strengths are reputed to come from strong competencies in marketing and store site selection, logistics and inventory management, and its own label product offerings. By the early 1990s, these competencies had already given the company a leading position in the United Kingdom. The company was generating strong free cash flows, and senior management had to decide how to use that cash. One strategy they settled on was overseas expansion. As they looked at international markets, they soon concluded the best opportunities were not in established markets, such as those in North America and Western Europe, where strong local competitors already existed, but in the emerging markets of Eastern Europe and Asia where there were few capable competitors but strong underlying growth trends.

Tesco's first international foray was into Hungary in 1994, when it acquired an initial 51 percent stake in Global, a 43-store, state-owned grocery chain. By 2004, Tesco was the market leader in Hungary, with some 60 stores and a 14 percent market share. In 1995, Tesco acquired 31 stores in Poland from Stavia; a year later it added 13 stores purchased from Kmart in the Czech Republic and Slovakia; and the following year it entered the Republic of Ireland.

Tesco's Asian expansion began in 1998 in Thailand when it purchased 75 percent of Lotus, a local food retailer with 13 stores. Building on that base, Tesco had 64 stores in Thailand by 2004. In 1999, the company entered South Korea when it partnered with Samsung to develop a chain of hypermarkets. This was followed by entry into Taiwan in 2000, Malaysia in 2002, and China in 2004. The move into China came after three years of careful research and discussions with potential partners. Like many other Western companies, Tesco was attracted to the Chinese market by its large size and rapid growth. In the end, Tesco settled on a 50/50 joint venture with Hymall, a hypermarket chain that is controlled by Ting Hsin, a Taiwanese group, which had been operating in China for six years. Currently, Hymall has 25 stores in China, and it plans to open another 10 each year. Ting Hsin is a well-capitalized enterprise in its own right, and it will match Tesco's investments, reducing the risks Tesco faces in China.

to devote considerable effort, time, and expense to learning the rules of the game. Pioneering costs include the costs of business failure if the firm, due to its ignorance of the foreign environment, makes major mistakes. A certain liability is associated with being a foreigner, and this liability is greater for foreign firms that enter a national market early.[6] Research seems to confirm that the probability of survival increases if an international business enters a national market after several other foreign firms have already done so.[7] The late entrant may benefit by observing and learning from the mistakes made by early entrants.

Pioneering costs also include the costs of promoting and establishing a product offering, including the costs of educating customers. These can be significant when the product being promoted is unfamiliar to local consumers. In contrast, later entrants may be able to ride on an early entrant's investments in learning and customer education by watching how the early entrant proceeded in the market, by avoiding costly mistakes made by the early entrant, and by exploiting the market potential created by the early entrant's investments in customer education. For example, KFC introduced the Chinese to American-style fast food, but a later entrant, McDonald's, has capitalized on the market in China.

An early entrant may be put at a severe disadvantage, relative to a later entrant, if regulations change in a way that diminishes the value of an early entrant's investments. This is a serious risk in many developing nations where the rules that govern business practices are still evolving. Early entrants can find themselves at a disadvantage if a subsequent change in regulations invalidates prior assumptions about the best business model for operating in that country.

In 2007, Tesco took its international expansion strategy to the next level when it announced it would enter the crowded U.S. grocery market with its Tesco Express concept. Already running in five countries, Tesco Express stores are smaller, high-quality neighborhood grocery outlets that feature a large selection of prepared and healthy foods. Tesco initially entered the West Coast, investing some £250 million per year, with profitability expected in 2010 when it planned to have 400 stores (the stores operate under the Fresh and Easy brand name). Although some question the wisdom of this move, others point out that in the United Kingdom Tesco has consistently outperformed the Asda chain that is owned by Walmart. Also, the Tesco Express format is not offered by anyone else in the United States.

As a result of these moves, by 2010 Tesco generated sales of £19.4 billion outside of the United Kingdom (its UK annual revenues were £43 billion). The addition of international stores has helped make Tesco the third-largest company in the global grocery market behind Walmart and Carrefour of France. Of the three, however, Tesco may be the most successful internationally. By 2010, all of its foreign ventures except the U.S. operation were making money.

In explaining the company's success, Tesco's managers have detailed a number of important factors. First, the company devotes considerable attention to transferring its core capabilities in retailing to its new ventures. At the same time, it does not send in an army of expatriate managers to run local operations, preferring to hire local managers and support them with a few operational experts from the United Kingdom. Second, the company believes that its partnering strategy in Asia has been a great asset. Tesco has teamed up with good companies that have a deep understanding of the markets in which they are participating but that lack Tesco's financial strength and retailing capabilities. Consequently, both Tesco and its partners have brought useful assets to the venture, increasing the probability of success. As the venture becomes established, Tesco has typically increased its ownership stake in its partner. By 2011, Tesco owned 99 percent of Homeplus, its South Korean hypermarket chain. When the venture was established, Tesco owned 51 percent. Third, the company has focused on markets with good growth potential but that lack strong indigenous competitors, which provides Tesco with ripe ground for expansion.[8]

SCALE OF ENTRY AND STRATEGIC COMMITMENTS

Another issue that an international business needs to consider when contemplating market entry is the scale of entry. Entering a market on a large scale involves the commitment of significant resources. Entering a market on a large scale implies rapid entry. Consider the entry of the Dutch insurance company ING into the U.S. insurance market in 1999. ING had to spend several billion dollars to acquire its U.S. operations. Not all firms have the resources necessary to enter on a large scale, and even some large firms prefer to enter foreign markets on a small scale and then build slowly as they become more familiar with the market.

The consequences of entering on a significant scale—entering rapidly—are associated with the value of the resulting strategic commitments.[9] A strategic commitment has a long-term impact and is difficult to reverse. Deciding to enter a foreign market on a significant scale is a major strategic commitment. Strategic commitments, such as rapid large-scale market entry, can have an important influence on the nature of competition in a market. For example, by entering the U.S. financial services market on a significant scale, ING signaled its commitment to the market. This will have several effects. On the positive side, it will make it easier for the company to attract customers and distributors (such as insurance agents). The scale of entry gives both customers and distributors reasons for believing that ING will remain in the market for the long run. The scale of entry may also give other foreign institutions considering entry into the United States pause; now they will have to compete not only against indigenous institutions in the

United States, but also against an aggressive and successful European institution. On the negative side, by committing itself heavily to the United States, ING may have fewer resources available to support expansion in other desirable markets, such as Japan. The commitment to the United States limits the company's strategic flexibility.

As suggested by the ING example, significant strategic commitments are neither unambiguously good nor bad. Rather, they tend to change the competitive playing field and unleash a number of changes, some of which may be desirable and some of which will not be. It is important for a firm to think through the implications of large-scale entry into a market and act accordingly. Of particular relevance is trying to identify how actual and potential competitors might react to large-scale entry into a market. Also, the large-scale entrant is more likely than the small-scale entrant to be able to capture first-mover advantages associated with demand preemption, scale economies, and switching costs.

The value of the commitments that flow from rapid large-scale entry into a foreign market must be balanced against the resulting risks and lack of flexibility associated with significant commitments. But strategic inflexibility can also have value. A famous example from military history illustrates the value of inflexibility. When Hernán Cortés landed in Mexico, he ordered his men to burn all but one of his ships. Cortés reasoned that by eliminating their only method of retreat, his men had no choice but to fight hard to win against the Aztecs—and ultimately they did.[10]

Balanced against the value and risks of the commitments associated with large-scale entry are the benefits of a small-scale entry. Small-scale entry allows a firm to learn about a foreign market while limiting the firm's exposure to that market. Small-scale entry is a way to gather information about a foreign market before deciding whether to enter on a significant scale and how best to enter. By giving the firm time to collect information, small-scale entry reduces the risks associated with a subsequent large-scale entry. But the lack of commitment associated with small-scale entry may make it more difficult for the small-scale entrant to build market share and to capture first-mover or early-mover advantages. The risk-averse firm that enters a foreign market on a small scale may limit its potential losses, but it may also miss the chance to capture first-mover advantages.

SUMMARY

There are no "right" decisions here, just decisions that are associated with different levels of risk and reward. Entering a large developing nation such as China or India before most other international businesses in the firm's industry, and entering on a large scale, will be associated with high levels of risk. In such cases, the liability of being foreign is increased by the absence of prior foreign entrants whose experience can be a useful guide. At the same time, the potential long-term rewards associated with such a strategy are great. The early large-scale entrant into a major developing nation may be able to capture significant first-mover advantages that will bolster its long-run position in that market.[11] This was what GM hoped to do when it entered China in 1997, and as of 2010 it seemed as if GM had captured a significant first-mover, or at least early-mover, advantage (see opening case). In contrast, entering developed nations such as Australia or Canada after other international businesses in the firm's industry, and entering on a small scale to first learn more about those markets, will be associated with much lower levels of risk. However, the potential long-term rewards are also likely to be lower because the firm is essentially forgoing the opportunity to capture first-mover advantages and because the lack of commitment signaled by small-scale entry may limit its future growth potential.



Being the first to enter a developing nation such as China is risky, but potentially rewarding.

This section has been written largely from the perspective of a business based in a developed country considering entry into foreign markets. Christopher Bartlett and Sumantra Ghoshal have pointed out the ability that businesses based in developing nations have to enter foreign markets and become global players.[12] Although such firms tend to be late entrants into foreign markets, and although their resources may be limited,

Bartlett and Ghoshal argue that such late movers can still succeed against well-established global competitors by pursuing appropriate strategies. In particular, Bartlett and Ghoshal argue that companies based in developing nations should use the entry of foreign multinationals as an opportunity to learn from these competitors by benchmarking their operations and performance against them. Furthermore, they suggest the local company may be able to find ways to differentiate itself from a foreign multinational, for example, by focusing on market niches that the multinational ignores or is unable to serve effectively if it has a standardized global product offering. Having improved its performance through learning and differentiated its product offering, the firm from a developing nation may then be able to pursue its own international expansion strategy. Even though the firm may be a late entrant into many countries, by benchmarking and then differentiating itself from early movers in global markets, the firm from the developing nation may still be able to build a strong international business presence. A good example of how this can work is given in the accompanying Management Focus, which looks at how Jollibee, a Philippines-based fast-food chain, has started to build a global presence in a market dominated by U.S. multinationals such as McDonald's and KFC.

Entry Modes

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Once a firm decides to enter a foreign market, the question arises as to the best mode of entry. Firms can use six different modes to enter foreign markets: exporting, turnkey projects, licensing, franchising, establishing joint ventures with a host-country firm, or setting up a new wholly owned subsidiary in the host country. Each entry mode has advantages and disadvantages. Managers need to consider these carefully when deciding which to use.[13]

EXPORTING

Many manufacturing firms begin their global expansion as exporters and only later switch to another mode for serving a foreign market. We take a close look at the mechanics of exporting in Chapter 16. Here we focus on the advantages and disadvantages of exporting as an entry mode.

Advantages

Exporting has two distinct advantages. First, it avoids the often substantial costs of establishing manufacturing operations in the host country. Second, exporting may help a firm achieve experience curve and location economies (see Chapter 13). By manufacturing the product in a centralized location and exporting it to other national markets, the firm may realize substantial scale economies from its global sales volume. This is how Sony came to dominate the global TV market, how Matsushita came to dominate the VCR market, how many Japanese automakers made inroads into the U.S. market, and how South Korean firms such as Samsung gained market share in computer memory chips.

Disadvantages

Exporting has a number of drawbacks. First, exporting from the firm's home base may not be appropriate if lower-cost locations for manufacturing the product can be found abroad (i.e., if the firm can realize location economies by moving production elsewhere). Thus, particularly for firms pursuing global or transnational strategies, it may be preferable to manufacture where the mix of factor conditions is most favorable from a value creation perspective and to export to the rest of the world from that location. This is not so much an argument against exporting as an argument against exporting from the firm's home country. Many U.S. electronics firms have moved some of their manufacturing to the Far East because of the availability of low-cost, highly skilled labor there. They then export from that location to the rest of the world, including the United States.

A second drawback to exporting is that high transport costs can make exporting uneconomical, particularly for bulk products. One way of getting around this is to manufacture



MANAGEMENT FOCUS

The Jollibee Phenomenon—A Philippine Multinational

Jollibee is one of the Philippines' phenomenal business success stories. Jollibee, which stands for "Jolly Bee," began operations in 1975 as a two-branch ice cream parlor. It later expanded its menu to include hot sandwiches and other meals. Encouraged by early success, Jollibee Foods Corporation was incorporated in 1978, with a network that had grown to seven outlets. In 1981, when Jollibee had 11 stores, McDonald's began to open stores in Manila. Many observers thought Jollibee would have difficulty competing against McDonald's. However, Jollibee saw this as an opportunity to learn from a very successful global competitor. Jollibee benchmarked its performance against that of McDonald's and started to adopt operational systems similar to those used at McDonald's to control its quality, cost, and service at the store level. This helped Jollibee to improve its performance.

As it came to better understand McDonald's business model, Jollibee began to look for a weakness in McDonald's global strategy. Jollibee executives concluded that McDonald's fare was too standardized for many locals, and that the local firm could gain share by tailoring its menu to local tastes. Jollibee's hamburgers were set apart by a secret mix of spices blended into the ground beef to make the burgers sweeter than those produced by McDonald's, appealing more to Philippine tastes. It also offered local fare, including various rice dishes, pineapple burgers, and banana *langka* and peach mango pies for desserts. By pursuing this strategy, Jollibee maintained a leadership position over the global giant. By 2006, Jollibee had over 540 stores in the Philippines, a market share of more than 60 percent, and revenues in excess of $600 million. McDonald's, in contrast, had about 250 stores.

In the mid-1980s, Jollibee had gained enough confidence to expand internationally. Its initial ventures were into neighboring Asian countries such as Indonesia, where it pursued the strategy of localizing the menu to better match local tastes, thereby differentiating itself from McDonald's. In 1987, Jollibee entered the Middle East, where a large contingent of expatriate Filipino workers provided a ready-made market for the company. The strategy of focusing on expatriates worked so well that in the late 1990s Jollibee decided to enter another foreign market where there was a large Filipino population—the United States. Between 1999 and 2004, Jollibee opened eight stores in the United States, all in California. Even though many believe the U.S. fast-food market is saturated, the stores have performed well. While the initial clientele was strongly biased toward the expatriate Filipino community, where Jollibee's brand awareness is high, non-Filipinos increasingly are coming to the restaurant. In the San Francisco store, which has been open the longest, more than half the customers are now non-Filipino. Today,

bulk products regionally. This strategy enables the firm to realize some economies from large-scale production and at the same time to limit its transport costs. For example, many multinational chemical firms manufacture their products regionally, serving several countries from one facility.

Another drawback is that tariff barriers can make exporting uneconomical. Similarly, the threat of tariff barriers by the host-country government can make it very risky. A fourth drawback to exporting arises when a firm delegates its marketing, sales, and service in each country where it does business to another company. This is a common approach for manufacturing firms that are just beginning to expand internationally. The other company may be a local agent, or it may be another multinational with extensive international distribution operations. Local agents often carry the products of competing firms and so have divided loyalties. In such cases, the local agent may not do as good a job as the firm would if it managed its marketing itself. Similar problems can occur when another multinational takes on distribution.

The way around such problems is to set up wholly owned subsidiaries in foreign nations to handle local marketing, sales, and service. By doing this, the firm can exercise tight control over marketing and sales in the country while reaping the cost advantages of manufacturing the product in a single location, or a few choice locations.

Jollibee has 37 international stores and a potentially bright future as a niche player in a market that has historically been dominated by U.S. multinationals.

Recently Jollibee has focused its attentions on two international markets, mainland China and India. It has more than 100 stores in China, which operate under the Yonghe brand name (and serve Chinese-style fast food). While it does not yet have a presence in India, the company is reported to be considering acquiring an Indian fast-food chain, although as with so many enterprises, Jollibee has slowed its expansion strategy in the wake of the 2008–2009 global financial crisis.[14]



Jollibee may be heading your way! Unlike many fast-food chains that have their roots within the United States, the Jollibee chain originated in the Philippines using McDonald's as a role model.

TURNKEY PROJECTS

Firms that specialize in the design, construction, and start-up of turnkey plants are common in some industries. In a **turnkey project**, the contractor agrees to handle every detail of the project for a foreign client, including the training of operating personnel. At completion of the contract, the foreign client is handed the "key" to a plant that is ready for full operation—hence, the term *turnkey*. This is a means of exporting process technology to other countries. Turnkey projects are most common in the chemical, pharmaceutical, petroleum-refining, and metal-refining industries, all of which use complex, expensive production technologies.

Advantages

The know-how required to assemble and run a technologically complex process, such as refining petroleum or steel, is a valuable asset. Turnkey projects are a way of earning great economic returns from that asset. The strategy is particularly useful where FDI is limited by host-government regulations. For example, the governments of many oil-rich countries have set out to build their own petroleum-refining industries, so they restrict

FDI in their oil-refining sectors. But because many of these countries lack petroleum-refining technology, they gain it by entering into turnkey projects with foreign firms that have the technology. Such deals are often attractive to the selling firm because without them, they would have no way to earn a return on their valuable know-how in that country. A turnkey strategy can also be less risky than conventional FDI. In a country with unstable political and economic environments, a longer-term investment might expose the firm to unacceptable political and/or economic risks (e.g., the risk of nationalization or of economic collapse).

Disadvantages

Three main drawbacks are associated with a turnkey strategy. First, the firm that enters into a turnkey deal will have no long-term interest in the foreign country. This can be a disadvantage if that country subsequently proves to be a major market for the output of the process that has been exported. One way around this is to take a minority equity interest in the operation. Second, the firm that enters into a turnkey project with a foreign enterprise may inadvertently create a competitor. For example, many of the Western firms that sold oil-refining technology to firms in Saudi Arabia, Kuwait, and other Gulf states now find themselves competing with these firms in the world oil market. Third, if the firm's process technology is a source of competitive advantage, then selling this technology through a turnkey project is also selling competitive advantage to potential and/or actual competitors.

LICENSING

A **licensing agreement** is an arrangement whereby a licensor grants the rights to intangible property to another entity (the licensee) for a specified period, and in return, the licensor receives a royalty fee from the licensee.[15] Intangible property includes patents, inventions, formulas, processes, designs, copyrights, and trademarks. For example, to enter the Japanese market, Xerox, inventor of the photocopier, established a joint venture with Fuji Photo that is known as Fuji Xerox. Xerox then licensed its xerographic know-how to Fuji Xerox. In return, Fuji Xerox paid Xerox a royalty fee equal to 5 percent of the net sales revenue that Fuji Xerox earned from the sales of photocopiers based on Xerox's patented know-how. In the Fuji Xerox case, the license was originally granted for 10 years, and it has been renegotiated and extended several times since. The licensing agreement between Xerox and Fuji Xerox also limited Fuji Xerox's direct sales to the Asian Pacific region (although Fuji Xerox does supply Xerox with photocopiers that are sold in North America under the Xerox label).[16]

Advantages

In the typical international licensing deal, the licensee puts up most of the capital necessary to get the overseas operation going. Thus, a primary advantage of licensing is that the firm does not have to bear the development costs and risks associated with opening a foreign market. Licensing is very attractive for firms lacking the capital to develop operations overseas. In addition, licensing can be attractive when a firm is unwilling to commit substantial financial resources to an unfamiliar or politically volatile foreign market. Licensing is also often used when a firm wishes to participate in a foreign market but is prohibited from doing so by barriers to investment. This was one of the original reasons for the formation of the Fuji Xerox joint venture. Xerox wanted to participate in the Japanese market but was prohibited from setting up a wholly owned subsidiary by the Japanese government. So Xerox set up the joint venture with Fuji and then licensed its know-how to the joint venture.

Finally, licensing is frequently used when a firm possesses some intangible property that might have business applications, but it does not want to develop those applications itself. For example, Bell Laboratories at AT&T originally invented the transistor circuit in the 1950s, but AT&T decided it did not want to produce transistors, so it licensed the technology to a number of other companies, such as Texas Instruments. Similarly,

Coca-Cola has licensed its famous trademark to clothing manufacturers, which have incorporated the design into clothing.

Disadvantages

Licensing has three serious drawbacks. First, it does not give a firm the tight control over manufacturing, marketing, and strategy that is required for realizing experience curve and location economies. Licensing typically involves each licensee setting up its own production operations. This severely limits the firm's ability to realize experience curve and location economies by producing its product in a centralized location. When these economies are important, licensing may not be the best way to expand overseas.

Second, competing in a global market may require a firm to coordinate strategic moves across countries by using profits earned in one country to support competitive attacks in another. By its very nature, licensing limits a firm's ability to do this. A licensee is unlikely to allow a multinational firm to use its profits (beyond those due in the form of royalty payments) to support a different licensee operating in another country.

A third problem with licensing is one that we encountered in Chapter 8 when we reviewed the economic theory of FDI. This is the risk associated with licensing technological know-how to foreign companies. Technological know-how constitutes the basis of many multinational firms' competitive advantage. Most firms wish to maintain control over how their know-how is used, and a firm can quickly lose control over its technology by licensing it. Many firms have made the mistake of thinking they could maintain control over their know-how within the framework of a licensing agreement. RCA Corporation, for example, once licensed its color TV technology to Japanese firms including Matsushita and Sony. The Japanese firms quickly assimilated the technology, improved on it, and used it to enter the U.S. market, taking substantial market share away from RCA.

There are ways of reducing this risk. One way is by entering into a cross-licensing agreement with a foreign firm. Under a cross-licensing agreement, a firm might license some valuable intangible property to a foreign partner, but in addition to a royalty payment, the firm might also request that the foreign partner license some of its valuable know-how to the firm. Such agreements are believed to reduce the risks associated with licensing technological know-how, since the licensee realizes that if it violates the licensing contract (by using the knowledge obtained to compete directly with the licensor), the licensor can do the same to it. Cross-licensing agreements enable firms to hold each other hostage, which reduces the probability that they will behave opportunistically toward each other.[17] Such cross-licensing agreements are increasingly common in high-technology industries. For example, the U.S. biotechnology firm Amgen licensed one of its key drugs, Nuprogene, to Kirin, the Japanese pharmaceutical company. The license gives Kirin the right to sell Nuprogene in Japan. In return, Amgen receives a royalty payment and, through a licensing agreement, gained the right to sell some of Kirin's products in the United States.

Another way of reducing the risk associated with licensing is to follow the Fuji Xerox model and link an agreement to license know-how with the formation of a joint venture in which the licensor and licensee take important equity stakes. Such an approach aligns the interests of licensor and licensee, because both have a stake in ensuring that the venture is successful. Thus, the risk that Fuji Photo might appropriate Xerox's technological know-how, and then compete directly against Xerox in the global photocopier market, was reduced by the establishment of a joint venture in which both Xerox and Fuji Photo had an important stake.

FRANCHISING

Franchising is similar to licensing, although franchising tends to involve longer-term commitments than licensing. **Franchising** is basically a specialized form of licensing in which the franchiser not only sells intangible property (normally a trademark) to the franchisee, but also insists that the franchisee agree to abide by strict rules as to how it



In 2011, *Entrepreneur* magazine ranked Hampton Hotels No. 1 in its annual Franchise 500 Top 10.

does business. The franchiser will also often assist the franchisee to run the business on an ongoing basis. As with licensing, the franchiser typically receives a royalty payment, which amounts to some percentage of the franchisee's revenues. Whereas licensing is pursued primarily by manufacturing firms, franchising is employed primarily by service firms.[18] McDonald's is a good example of a firm that has grown by using a franchising strategy. McDonald's strict rules as to how franchisees should operate a restaurant extend to control over the menu, cooking methods, staffing policies, and design and location. McDonald's also organizes the supply chain for its franchisees and provides management training and financial assistance.[19]

Advantages

The advantages of franchising as an entry mode are very similar to those of licensing. The firm is relieved of many of the costs and risks of opening a foreign market on its own. Instead, the franchisee typically assumes those costs and risks. This creates a good incentive for the franchisee to build a profitable operation as quickly as possible. Thus, using a franchising strategy, a service firm can build a global presence quickly and at a relatively low cost and risk, as McDonald's has.

Disadvantages

The disadvantages are less pronounced than in the case of licensing. Since franchising is often used by service companies, there is no reason to consider the need for coordination of manufacturing to achieve experience curve and location economies. But franchising may inhibit the firm's ability to take profits out of one country to support competitive attacks in another. A more significant disadvantage of franchising is quality control. The foundation of franchising arrangements is that the firm's brand name conveys a message to consumers about the quality of the firm's product. Thus, a business traveler checking in at a Four Seasons hotel in Hong Kong can reasonably expect the same quality of room, food, and service that she would receive in New York. The Four Seasons name is supposed to guarantee consistent product quality. This presents a problem in that foreign franchisees may not be as concerned about quality as they are supposed to be, and the result of poor quality can extend beyond lost sales in a particular foreign market to a decline in the firm's worldwide reputation. For example, if the business traveler has a bad experience at the Four Seasons in Hong Kong, she may never go to another Four Seasons hotel and may urge her colleagues to do likewise. The geographical distance of the firm from its foreign franchisees can make poor quality difficult to detect. In addition, the sheer numbers of franchisees—in the case of McDonald's, tens of thousands—can make quality control difficult. Due to these factors, quality problems may persist.

One way around this disadvantage is to set up a subsidiary in each country in which the firm expands. The subsidiary might be wholly owned by the company or a joint venture with a foreign company. The subsidiary assumes the rights and obligations to establish franchises throughout the particular country or region. McDonald's, for example, establishes a master franchisee in many countries. Typically, this master franchisee is a joint venture between McDonald's and a local firm. The proximity and the smaller number of franchises to oversee reduce the quality control challenge. In addition, because the

subsidiary (or master franchisee) is at least partly owned by the firm, the firm can place its own managers in the subsidiary to help ensure that it is doing a good job of monitoring the franchises. This organizational arrangement has proven very satisfactory for McDonald's, KFC, and others.

JOINT VENTURES

A **joint venture** entails establishing a firm that is jointly owned by two or more otherwise independent firms. Fuji Xerox, for example, was set up as a joint venture between Xerox and Fuji Photo. Establishing a joint venture with a foreign firm has long been a popular mode for entering a new market. As we saw in the opening case, General Motors used a joint-venture strategy to enter the Chinese automobile market. The most typical joint venture is a 50/50 venture, in which there are two parties, each of which holds a 50 percent ownership stake and contributes a team of managers to share operating control. This was the case with the Fuji–Xerox joint venture until 2001; it is now a 25/75 venture with Xerox holding 25 percent. The GM SAIC venture in China was a 50/50 venture until 2010, which it became a 51/49 venture, with SAIC holding the 51 percent stake. Some firms, however, have sought joint ventures in which they have a majority share and thus tighter control.[20]

Advantages

Joint ventures have a number of advantages. First, a firm benefits from a local partner's knowledge of the host country's competitive conditions, culture, language, political systems, and business systems (this was one reason GM entered into a joint venture with SAIC in China; see the opening case). Thus, for many U.S. firms, joint ventures have involved the U.S. company providing technological know-how and products and the local partner providing the marketing expertise and the local knowledge necessary for competing in that country. Second, when the development costs and/or risks of opening a foreign market are high, a firm might gain by sharing these costs and or risks with a local partner. Third, in many countries, political considerations make joint ventures the only feasible entry mode (again, as was the case with GM's joint venture with SAIC). Research suggests joint ventures with local partners face a low risk of being subject to nationalization or other forms of adverse government interference.[21] This appears to be because local equity partners, who may have some influence on host-government policy, have a vested interest in speaking out against nationalization or government interference.

Disadvantages

Despite these advantages, there are major disadvantages with joint ventures. First, as with licensing, a firm that enters into a joint venture risks giving control of its technology to its partner. Thus, a proposed joint venture in 2002 between Boeing and Mitsubishi Heavy Industries to build a new wide-body jet (the 787) raised fears that Boeing might unwittingly give away its commercial airline technology to the Japanese. However, joint-venture agreements can be constructed to minimize this risk. One option is to hold majority ownership in the venture. This allows the dominant partner to exercise greater control over its technology. But it can be difficult to find a foreign partner who is willing to settle for minority ownership. Another option is to "wall off" from a partner technology that is central to the core competence of the firm, while sharing other technology.

A second disadvantage is that a joint venture does not give a firm the tight control over subsidiaries that it might need to realize experience curve or location economies. Nor does it give a firm the tight control over a foreign subsidiary that it might need for engaging in coordinated global attacks against its rivals. Consider the entry of Texas Instruments (TI) into the Japanese semiconductor market. When TI established semiconductor facilities in Japan, it did so for the dual purpose of checking Japanese manufacturers' market share and limiting their cash available for invading TI's global market. In other words, TI was engaging in global strategic coordination. To implement this strategy, TI's

subsidiary in Japan had to be prepared to take instructions from corporate headquarters regarding competitive strategy. The strategy also required the Japanese subsidiary to run at a loss if necessary. Few if any potential joint-venture partners would have been willing to accept such conditions, since it would have necessitated a willingness to accept a negative return on investment. Indeed, many joint ventures establish a degree of autonomy that would make such direct control over strategic decisions all but impossible to establish.[22] Thus, to implement this strategy, TI set up a wholly owned subsidiary in Japan.

A third disadvantage with joint ventures is that the shared ownership arrangement can lead to conflicts and battles for control between the investing firms if their goals and objectives change or if they take different views as to what the strategy should be. This was apparently not a problem with the Fuji Xerox joint venture. According to Yotaro Kobayashi, the chairman of Fuji Xerox, a primary reason is that both Xerox and Fuji Photo adopted an arm's-length relationship with Fuji Xerox, giving the venture's management considerable freedom to determine its own strategy.[23] However, much research indicates that conflicts of interest over strategy and goals often arise in joint ventures. These conflicts tend to be greater when the venture is between firms of different nationalities, and they often end in the dissolution of the venture.[24] Such conflicts tend to be triggered by shifts in the relative bargaining power of venture partners. For example, in the case of ventures between a foreign firm and a local firm, as a foreign partner's knowledge about local market conditions increases, it depends less on the expertise of a local partner. This increases the bargaining power of the foreign partner and ultimately leads to conflicts over control of the venture's strategy and goals.[25] Some firms have sought to limit such problems by entering into joint ventures in which one partner has a controlling interest.

WHOLLY OWNED SUBSIDIARIES

In a **wholly owned subsidiary**, the firm owns 100 percent of the stock. Establishing a wholly owned subsidiary in a foreign market can be done two ways. The firm either can set up a new operation in that country, often referred to as a greenfield venture, or it can acquire an established firm in that host nation and use that firm to promote its products.[26] For example, ING's strategy for entering the U.S. insurance market was to acquire established U.S. enterprises, rather than try to build an operation from the ground floor.

Advantages

There are several clear advantages of wholly owned subsidiaries. First, when a firm's competitive advantage is based on technological competence, a wholly owned subsidiary will often be the preferred entry mode because it reduces the risk of losing control over that competence. (See Chapter 8 for more details.) Many high-tech firms prefer this entry mode for overseas expansion (e.g., firms in the semiconductor, electronics, and pharmaceutical industries). Second, a wholly owned subsidiary gives a firm tight control over operations in different countries. This is necessary for engaging in global strategic coordination (i.e., using profits from one country to support competitive attacks in another).

Third, a wholly owned subsidiary may be required if a firm is trying to realize location and experience curve economies (as firms pursuing global and transnational strategies try to do). As we saw in Chapter 11, when cost pressures are intense, it may pay a firm to configure its value chain in such a way that the value added at each stage is maximized. Thus, a national subsidiary may specialize in manufacturing only part of the product line or certain components of the end product, exchanging parts and products with other subsidiaries in the firm's global system. Establishing such a global production system requires a high degree of control over the operations of each affiliate. The various operations must be prepared to accept centrally determined decisions as to how they will produce, how much they will produce, and how their output will be priced for transfer to the next operation. Because licensees or joint-venture partners are unlikely to accept such a subservient role, establishing wholly owned subsidiaries may be necessary. Finally, establishing a wholly owed subsidiary gives the firm a 100 percent share in the profits generated in a foreign market.

Disadvantage

Establishing a wholly owned subsidiary is generally the most costly method of serving a foreign market from a capital investment standpoint. Firms doing this must bear the full capital costs and risks of setting up overseas operations. The risks associated with learning to do business in a new culture are less if the firm acquires an established host-country enterprise. However, acquisitions raise additional problems, including those associated with trying to marry divergent corporate cultures. These problems may more than offset any benefits derived by acquiring an established operation. Because the choice between greenfield ventures and acquisitions is such an important one, we shall discuss it in more detail later in the chapter.

Selecting an Entry Mode LO3

As the preceding discussion demonstrated, all the entry modes have advantages and disadvantages, as summarized in Table 15.1. Thus, trade-offs are inevitable when selecting an entry mode. For example, when considering entry into an unfamiliar country with a track record for discriminating against foreign-owned enterprises when awarding government contracts, a firm might favor a joint venture with a local enterprise. Its rationale might be that the local partner will help it establish operations in an unfamiliar environment and will help the company win government contracts. However, if the firm's core competence is based on proprietary technology, entering a joint venture might risk losing control of that technology to the joint-venture partner, in which case the strategy may seem unattractive. Despite the existence of such trade-offs, it is possible to make some generalizations about the optimal choice of entry mode.[27]

Entry Mode	Advantages	Disadvantages
Exporting	Ability to realize location and experience curve economies	High transport costs Trade barriers Problems with local marketing agents
Turnkey contracts	Ability to earn returns from process technology skills in countries where FDI is restricted	Creating efficient competitors Lack of long-term market presence
Licensing	Low development costs and risks	Lack of control over technology Inability to realize location and experience curve economies Inability to engage in global strategic coordination
Franchising	Low development costs and risks	Lack of control over quality Inability to engage in global strategic coordination
Joint ventures	Access to local partner's knowledge Sharing development costs and risks Politically acceptable	Lack of control over technology Inability to engage in global strategic coordination Inability to realize location and experience economies
Wholly owned subsidiaries	Protection of technology Ability to engage in global strategic coordination Ability to realize location and experience economies	High costs and risks

TABLE 15.1

Advantages and Disadvantages of Entry Modes

CORE COMPETENCIES AND ENTRY MODE

We saw in Chapter 13 that firms often expand internationally to earn greater returns from their core competencies, transferring the skills and products derived from their core competencies to foreign markets where indigenous competitors lack those skills. The optimal entry mode for these firms depends to some degree on the nature of their core competencies. A distinction can be drawn between firms whose core competency is in technological know-how and those whose core competency is in management know-how.

Technological Know-how

As was observed in Chapter 8, if a firm's competitive advantage (its core competence) is based on control over proprietary technological know-how, licensing and joint-venture arrangements should be avoided if possible to minimize the risk of losing control over that technology. Thus, if a high-tech firm sets up operations in a foreign country to profit from a core competency in technological know-how, it will probably do so through a wholly owned subsidiary. This rule should not be viewed as hard and fast, however. Sometimes a licensing or joint-venture arrangement can be structured to reduce the risk of licensees or joint-venture partners expropriating technological know-how. Another exception exists when a firm perceives its technological advantage to be only transitory, when it expects rapid imitation of its core technology by competitors. In such cases, the firm might want to license its technology as rapidly as possible to foreign firms to gain global acceptance for its technology before the imitation occurs.[28] Such a strategy has some advantages. By licensing its technology to competitors, the firm may deter them from developing their own, possibly superior, technology. Further, by licensing its technology, the firm may establish its technology as the dominant design in the industry (as Matsushita did with its VHS format for VCRs). This may ensure a steady stream of royalty payments. However, the attractions of licensing are frequently outweighed by the risks of losing control over technology, and if this is a risk, licensing should be avoided.

Management Know-How

The competitive advantage of many service firms is based on management know-how (e.g., McDonald's, Starbucks). For such firms, the risk of losing control over the management skills to franchisees or joint-venture partners is not that great. These firms' valuable asset is their brand name, and brand names are generally well protected by international laws pertaining to trademarks. Given this, many of the issues arising in the case of technological know-how are of less concern here. As a result, many service firms favor a combination of franchising and subsidiaries to control the franchises within particular countries or regions. The subsidiaries may be wholly owned or joint ventures, but most service firms have found that joint ventures with local partners work best for the controlling subsidiaries. A joint venture is often politically more acceptable and brings a degree of local knowledge to the subsidiary.

PRESSURES FOR COST REDUCTIONS AND ENTRY MODE

The greater the pressures for cost reductions are, the more likely a firm will want to pursue some combination of exporting and wholly owned subsidiaries. By manufacturing in those locations where factor conditions are optimal and then exporting to the rest of the world, a firm may be able to realize substantial location and experience curve economies. The firm might then want to export the finished product to marketing subsidiaries based in various countries. These subsidiaries will typically be wholly owned and have the responsibility for overseeing distribution in their particular countries. Setting up wholly owned marketing subsidiaries is preferable to joint-venture arrangements and to using foreign marketing agents because it gives the firm tight control that might be required for coordinating a globally dispersed value chain. It also gives the firm the ability to use the profits generated in one market to improve its competitive position in another market. In other words, firms pursuing global standardization or transnational strategies tend to prefer establishing wholly owned subsidiaries.

Greenfield Venture or Acquisition? LO4

A firm can establish a wholly owned subsidiary in a country by building a subsidiary from the ground up, the so-called greenfield strategy, or by acquiring an enterprise in the target market.[29] The volume of cross-border acquisitions has been growing at a rapid rate for two decades. Over most of the past two decades, between 40 and 80 percent of all FDI inflows have been in the form of mergers and acquisitions. In 2001, for example, mergers and acquisitions accounted for 80 percent of all FDI inflows. In 2004 the figure was 51 percent, or some $381 billion. In 2009, however, the figure was only 22 percent, or some $250 billion.[30] The relative low figure recorded in 2009 reflects the impact of the global economic crisis, which depressed equity values worldwide and made cross-border mergers and acquisitions less attractive as an entry mode.

PROS AND CONS OF ACQUISITIONS

Acquisitions have three major points in their favor. First, they are quick to execute. By acquiring an established enterprise, a firm can rapidly build its presence in the target foreign market. When the German automobile company Daimler-Benz decided it needed a bigger presence in the U.S. automobile market, it did not increase that presence by building new factories to serve the United States, a process that would have taken years. Instead, it acquired the No. 3 U.S. automobile company, Chrysler, and merged the two operations to form DaimlerChrysler (Daimler spun off Chrysler into a private equity firm in 2007). When the Spanish telecommunications service provider Telefonica wanted to build a service presence in Latin America, it did so through a series of acquisitions, purchasing telecommunications companies in Brazil and Argentina. In these cases, the firms made acquisitions because they knew that was the quickest way to establish a sizable presence in the target market.

Second, in many cases firms make acquisitions to preempt their competitors. The need for preemption is particularly great in markets that are rapidly globalizing, such as telecommunications, where a combination of deregulation within nations and liberalization of regulations governing cross-border foreign direct investment has made it much easier for enterprises to enter foreign markets through acquisitions. Such markets may see concentrated waves of acquisitions as firms race each other to attain global scale. In the telecommunications industry, for example, regulatory changes triggered what can be called a feeding frenzy, with firms entering each other's markets via acquisitions to establish a global presence. These included the $60 billion acquisition of Air Touch Communications in the United States by the British company Vodafone, which was the largest acquisition ever; the $13 billion acquisition of One 2 One in Britain by the German company Deutsche Telekom; and the $6.4 billion acquisition of Excel Communications in the United States by Teleglobe of Canada, all of which occurred in 1998 and 1999.[31] A similar wave of cross-border acquisitions occurred in the global automobile industry over the same time period, with Daimler acquiring Chrysler, Ford acquiring Volvo, and Renault acquiring Nissan.

Third, managers may believe acquisitions to be less risky than greenfield ventures. When a firm makes an acquisition, it buys a set of assets that are producing a known revenue and profit stream. In contrast, the revenue and profit stream that a greenfield venture might generate is uncertain because it does not yet exist. When a firm makes an acquisition in a foreign market, it not only acquires a set of tangible assets, such as factories, logistics systems, customer service systems, and so on, but it also acquires valuable intangible assets including a local brand name and managers' knowledge of the business environment in that nation. Such knowledge can reduce the risk of mistakes caused by ignorance of the national culture.

Despite the arguments for making acquisitions, acquisitions often produce disappointing results.[32] For example, a study by Mercer Management Consulting looked at 150 acquisitions worth more than $500 million each that were undertaken between January 1990 and July 1995.[33] The Mercer study concluded that 50 percent of these acquisitions

eroded shareholder value, while another 33 percent created only marginal returns. Only 17 percent were judged to be successful. Similarly, a study by KPMG, an accounting and management consulting company, looked at 700 large acquisitions between 1996 and 1998. The study found that while some 30 percent of these actually created value for the acquiring company, 31 percent destroyed value, and the remainder had little impact.[34] A similar study by McKenzie & Co. estimated that some 70 percent of mergers and acquisitions failed to achieve expected revenue synergies.[35] In a seminal study of the post-acquisition performance of acquired companies, David Ravenscraft and Mike Scherer concluded that on average the profits and market shares of acquired companies declined following acquisition.[36] They also noted that a smaller but substantial subset of those companies experienced traumatic difficulties, which ultimately led to their being sold by the acquiring company. Ravenscraft and Scherer's evidence suggests that many acquisitions destroy rather than create value. While most of this research has looked at domestic acquisitions, the findings probably also apply to cross-border acquisitions.[37]

Why Do Acquisitions Fail?

Acquisitions fail for several reasons. First, the acquiring firms often overpay for the assets of the acquired firm. The price of the target firm can get bid up if more than one firm is interested in its purchase, as is often the case. In addition, the management of the acquiring firm is often too optimistic about the value that can be created via an acquisition and is thus willing to pay a significant premium over a target firm's market capitalization. This is called the "hubris hypothesis" of why acquisitions fail. The hubris hypothesis postulates that top managers typically overestimate their ability to create value from an acquisition, primarily because rising to the top of a corporation has given them an exaggerated sense of their own capabilities.[38] For example, Daimler acquired Chrysler in 1998 for $40 billion, a premium of 40 percent over the market value of Chrysler before the takeover bid. Daimler paid this much because it thought it could use Chrysler to help it grow market share in the United States. At the time, Daimler's management issued bold announcements about the "synergies" that would be created from combining the operations of the two companies. Executives believed they could attain greater scale economies from the global presence, take costs out of the German and U.S. operations, and boost the profitability of the combined entity. However, within a year of the acquisition, Daimler's German management was faced with a crisis at Chrysler, which was suddenly losing money due to weak sales in the United States. In retrospect, Daimler's management had been far too optimistic about the potential for future demand in the U.S. auto market and about the opportunities for creating value from "synergies." Daimler acquired Chrysler at the end of a multiyear boom in U.S. auto sales and paid a large premium over Chrysler's market value just before demand slumped (and in 2007, in an admission of failure, Daimler sold its Chrysler unit to a private equity firm).[39]

Second, many acquisitions fail because there is a clash between the cultures of the acquiring and acquired firms. After an acquisition, many acquired companies experience high management turnover, possibly because their employees do not like the acquiring company's way of doing things.[40] This happened at DaimlerChrysler; many senior managers left Chrysler in the first year after the merger. Apparently, Chrysler executives disliked the dominance in decision making by Daimler's German managers, while the Germans resented that Chrysler's American managers were paid two to three times as much as their German counterparts. These cultural differences created tensions, which ultimately exhibited themselves in high management turnover at Chrysler.[41] The loss of management talent and expertise can materially harm the performance of the acquired unit.[42] This may be particularly problematic in an international business, where management of the acquired unit may have valuable local knowledge that can be difficult to replace.

Third, many acquisitions fail because attempts to realize synergies by integrating the operations of the acquired and acquiring entities often run into roadblocks and take much longer than forecast. Differences in management philosophy and company culture

can slow the integration of operations. Differences in national culture may exacerbate these problems. Bureaucratic haggling between managers also complicates the process. Again, this reportedly occurred at DaimlerChrysler, where grand plans to integrate the operations of the two companies were bogged down by endless committee meetings and by simple logistical considerations such as the six-hour time difference between Detroit and Germany. By the time an integration plan had been worked out, Chrysler was losing money, and Daimler's German managers suddenly had a crisis on their hands.

Finally, many acquisitions fail due to inadequate pre-acquisition screening.[43] Many firms decide to acquire other firms without thoroughly analyzing the potential benefits and costs. They often move with undue haste to execute the acquisition, perhaps because they fear another competitor may preempt them. After the acquisition, however, many acquiring firms discover that instead of buying a well-run business, they have purchased a troubled organization. This may be a particular problem in cross-border acquisitions because the acquiring firm may not fully understand the target firm's national culture and business system.

Reducing the Risks of Failure

These problems can all be overcome if the firm is careful about its acquisition strategy.[44] Screening of the foreign enterprise to be acquired, including a detailed auditing of operations, financial position, and management culture, can help to make sure the firm (1) does not pay too much for the acquired unit, (2) does not uncover any nasty surprises after the acquisition, and (3) acquires a firm whose organization culture is not antagonistic to that of the acquiring enterprise. It is also important for the acquirer to allay any concerns that management in the acquired enterprise might have. The objective should be to reduce unwanted management attrition after the acquisition. Finally, managers must move rapidly after an acquisition to put an integration plan in place and to act on that plan. Some people in both the acquiring and acquired units will try to slow or stop any integration efforts, particularly when losses of employment or management power are involved, and managers should have a plan for dealing with such impediments before they arise.

PROS AND CONS OF GREENFIELD VENTURES

The big advantage of establishing a greenfield venture in a foreign country is that it gives the firm a much greater ability to build the kind of subsidiary company that it wants. For example, it is much easier to build an organization culture from scratch than it is to change the culture of an acquired unit. Similarly, it is much easier to establish a set of operating routines in a new subsidiary than it is to convert the operating routines of an acquired unit. This is a very important advantage for many international businesses, where transferring products, competencies, skills, and know-how from the established operations of the firm to the new subsidiary are principal ways of creating value. For example, when Lincoln Electric, the U.S. manufacturer of arc welding equipment, first ventured overseas in the mid-1980s, it did so by acquisitions, purchasing arc welding equipment companies in Europe. However, Lincoln's competitive advantage in the United States was based on a strong organizational culture and a unique set of incentives that encouraged its employees to do everything possible to increase productivity. Lincoln found through bitter experience that it was almost impossible to transfer its organizational culture and incentives to acquired firms, which had their own distinct organizational cultures and incentives. As a result, the firm switched its entry strategy in the mid-1990s and began to enter foreign countries by establishing greenfield ventures, building operations from the ground up. While this strategy takes more time to execute, Lincoln has found that it yields greater long-run returns than the acquisition strategy.

Set against this significant advantage are the disadvantages of establishing a greenfield venture. Greenfield ventures are slower to establish. They are also risky. As with any new venture, a degree of uncertainty is associated with future revenue and

profit prospects. However, if the firm has already been successful in other foreign markets and understands what it takes to do business in other countries, these risks may not be that great. For example, having already gained great knowledge about operating internationally, the risk to McDonald's of entering yet another country is probably not that great. Also, greenfield ventures are less risky than acquisitions in the sense that there is less potential for unpleasant surprises. A final disadvantage is the possibility of being preempted by more aggressive global competitors who enter via acquisitions and build a big market presence that limits the market potential for the greenfield venture.

GREENFIELD VENTURE OR ACQUISITION?

The choice between acquisitions and greenfield ventures is not an easy one. Both modes have their advantages and disadvantages. In general, the choice will depend on the circumstances confronting the firm. If the firm is seeking to enter a market where there are already well-established incumbent enterprises, and where global competitors are also interested in establishing a presence, it may pay the firm to enter via an acquisition. In such circumstances, a greenfield venture may be too slow to establish a sizable presence. However, if the firm is going to make an acquisition, its management should be cognizant of the risks associated with acquisitions that were discussed earlier and consider these when determining which firms to purchase. It may be better to enter by the slower route of a greenfield venture than to make a bad acquisition.

If the firm is considering entering a country where there are no incumbent competitors to be acquired, then a greenfield venture may be the only mode. Even when incumbents exist, if the competitive advantage of the firm is based on the transfer of organizationally embedded competencies, skills, routines, and culture, it may still be preferable to enter via a greenfield venture. Things such as skills and organizational culture, which are based on significant knowledge that is difficult to articulate and codify, are much easier to embed in a new venture than they are in an acquired entity, where the firm may have to overcome the established routines and culture of the acquired firm. Thus, as our earlier examples suggest, firms such as McDonald's and Lincoln Electric prefer to enter foreign markets by establishing greenfield ventures.

LO5 Strategic Alliances

Strategic alliances refer to cooperative agreements between potential or actual competitors. In this section, we are concerned specifically with strategic alliances between firms from different countries. Strategic alliances run the range from formal joint ventures, in which two or more firms have equity stakes (e.g., Fuji Xerox), to short-term contractual agreements, in which two companies agree to cooperate on a particular task (such as developing a new product). Collaboration between competitors is fashionable; recent decades have seen an explosion in the number of strategic alliances.

THE ADVANTAGES OF STRATEGIC ALLIANCES

Firms ally themselves with actual or potential competitors for various strategic purposes.[45] First, strategic alliances may facilitate entry into a foreign market. For example, many firms believe that if they are to successfully enter the Chinese market, they need a local partner who understands business conditions and who has good connections (or *guanxi*—see Chapter 4). Thus, in 2004 Warner Brothers entered into a joint venture with two Chinese partners to produce and distribute films in China. As a foreign film company, Warner found that if it wanted to produce films on its own for the Chinese market it had to go through a complex approval process for every film, and it had to farm out distribution to a local company, which made doing business in China very difficult. Due to the participation of Chinese firms, however, the joint-venture films will go through a streamlined approval process, and the venture will be able to distribute any films it produces.

Also, the joint venture will be able to produce films for Chinese TV, something that foreign firms are not allowed to do.[46]

Strategic alliances also allow firms to share the fixed costs (and associated risks) of developing new products or processes. An alliance between Boeing and a number of Japanese companies to build Boeing's latest commercial jetliner, the 787, was motivated by Boeing's desire to share the estimated $8 billion investment required to develop the aircraft. For another example of cost sharing, see the accompanying Management Focus, which discusses the strategic alliances between Cisco and Fujitsu.

Third, an alliance is a way to bring together complementary skills and assets that neither company could easily develop on its own.[47] In 2003, for example, Microsoft and Toshiba established an alliance aimed at developing embedded microprocessors (essentially tiny computers) that can perform a variety of entertainment functions in an automobile (e.g., run a backseat DVD player or a wireless Internet connection). The processors run a version of Microsoft's Windows CE operating system. Microsoft brings its software engineering skills to the alliance and Toshiba its skills in developing microprocessors.[48] The alliance between Cisco and Fujitsu was also formed to share know-how (see the Management Focus).

Fourth, it can make sense to form an alliance that will help the firm establish technological standards for the industry that will benefit the firm. For example, in 2011 Nokia, one of the leading makers of smartphones, entered into an alliance with Microsoft under which Nokia agreed to license and use Microsoft's Windows Mobile operating system in Nokia's phones. The motivation for the alliance was in part to help establish Windows Mobile as the industry standard for smartphones as opposed to the rival operating systems such as Apple's iPhone and Google's Android.

THE DISADVANTAGES OF STRATEGIC ALLIANCES

The advantages we have discussed can be very significant. Despite this, some commentators have criticized strategic alliances on the grounds that they give competitors a low-cost route to new technology and markets.[49] For example, a few years ago some commentators argued that many strategic alliances between U.S. and Japanese firms were part of an implicit Japanese strategy to keep high-paying, high-value-added jobs in Japan while gaining the project engineering and production process skills that underlie the competitive success of many U.S. companies.[50] They argued that Japanese success in the machine tool and semiconductor industries was built on U.S. technology acquired through strategic alliances. And they argued that U.S. managers were aiding the Japanese by entering alliances that channel new inventions to Japan and provide a U.S. sales and distribution network for the resulting products. Although such deals may generate short-term profits, so the argument goes, in the long run the result is to "hollow out" U.S. firms, leaving them with no competitive advantage in the global marketplace.

These critics have a point; alliances have risks. Unless a firm is careful, it can give away more than it receives. But there are so many examples of apparently successful alliances between firms—including alliances between U.S. and Japanese firms—that the critics' position seems extreme. It is difficult to see how the Microsoft–Toshiba alliance, the Boeing–Mitsubishi alliance for the 787, and the Fuji–Xerox alliance fit the critics' thesis. In these cases, both partners seem to have gained from the alliance. Why do some alliances benefit both firms while others benefit one firm and hurt the other? The next section provides an answer to this question.

MAKING ALLIANCES WORK

The failure rate for international strategic alliances seems to be high. One study of 49 international strategic alliances found that two-thirds run into serious managerial and financial troubles within two years of their formation, and that although many of these problems are solved, 33 percent are ultimately rated as failures by the parties involved.[51]



MANAGEMENT FOCUS

Cisco and Fujitsu

In late 2004 Cisco Systems, the world's largest manufacturer of Internet routers, entered into an alliance with the Japanese computer, electronics, and telecommunications equipment firm Fujitsu. The stated purpose of the alliance was to jointly develop next-generation high-end routers for sales in Japan. Routers are the digital switches that sit at the heart of the Internet and direct traffic. Although Cisco has long held the leading share in the market for routers—it pioneered the original router technology—it faces increasing competition from other firms such as Juniper Technologies and China's fast-growing Huawei Technologies. At the same time, demand in the market is shifting as more and more telecommunications companies adopt Internet-based telecommunications services. While Cisco has long had a strong global presence, management also believed the company needed to have better presence in Japan, which is shifting rapidly to second-generation high-speed Internet-based telecommunications networks.

By entering into an alliance with Fujitsu, Cisco believes it can achieve a number of goals. First, both firms can pool their R&D efforts, which will enable them to share complementary technology and develop products quicker, thereby gaining an advantage over competitors. Second, by combining Cisco's proprietary leading-edge router technology with Fujitsu's production expertise, the companies believe they can produce products that are more reliable than those currently offered. Third, Fujitsu will give Cisco a stronger sales presence in Japan. Fujitsu has good links with Japan's telecommunications companies and a well-earned reputation for reliability. It will leverage these assets to sell the routers produced by the alliance, which will be co-branded as Fujitsu-Cisco products. Fourth, sales may be further enhanced by bundling the co-branded routers together with other telecommunications equipment that Fujitsu sells and marketing an entire solution to customers. Fujitsu sells many telecommunications products, but lacks a strong presence in routers. Cisco is strong in routers, but lacks strong offerings elsewhere. The combination of the two companies' products will enable Fujitsu to offer Japan's telecommunications companies "end-to-end" communications solutions. Because many companies prefer to purchase their equipment from a single provider, this should drive sales.

The alliance introduced its first products in May 2006. If it is successful, both firms should benefit from the alliance. Development costs will be lower than if they did not cooperate. Cisco will grow its sales in Japan, and Fujitsu can use the co-branded routers to fill out its product line and sell more bundles of products to Japan's telecommunications companies.[52]

The success of an alliance seems to be a function of three main factors: partner selection, alliance structure, and the manner in which the alliance is managed.

Partner Selection

One key to making a strategic alliance work is to select the right ally. A good ally, or partner, has three characteristics. First, a good partner helps the firm achieve its strategic goals, whether they are market access, sharing the costs and risks of product development, or gaining access to critical core competencies. The partner must have capabilities that the firm lacks and that it values. Second, a good partner shares the firm's vision for the purpose of the alliance. If two firms approach an alliance with radically different agendas, the chances are great that the relationship will not be harmonious, will not flourish, and will end in divorce. Third, a good partner is unlikely to try to opportunistically exploit the alliance for its own ends, that is, to expropriate the firm's technological know-how while giving away little in return. In this respect, firms with reputations for "fair play" to maintain probably make the best allies. For example, companies such as General Electric are involved in so many strategic alliances that it would not pay the company to trample over individual alliance partners.[53] This would tarnish GE's reputation of being a good ally and would make it more difficult for GE to attract alliance

partners. Because IBM attaches great importance to its alliances, it is unlikely to engage in the kind of opportunistic behavior that critics highlight. Similarly, their reputations make it less likely (but by no means impossible) that such Japanese firms as Sony, Toshiba, and Fuji, which have histories of alliances with non-Japanese firms, would opportunistically exploit an alliance partner.

To select a partner with these three characteristics, a firm needs to conduct comprehensive research on potential alliance candidates. To increase the probability of selecting a good partner, the firm should:

1. Collect as much pertinent, publicly available information on potential allies as possible.
2. Gather data from informed third parties. These include firms that have had alliances with the potential partners, investment bankers that have had dealings with them, and former employees.
3. Get to know the potential partner as well as possible before committing to an alliance. This should include face-to-face meetings between senior managers (and perhaps middle-level managers) to ensure that the chemistry is right.

Alliance Structure

A partner having been selected, the alliance should be structured so that the firm's risks of giving too much away to the partner are reduced to an acceptable level. First, alliances can be designed to make it difficult (if not impossible) to transfer technology not meant to be transferred. The design, development, manufacture, and service of a product manufactured by an alliance can be structured so as to wall off sensitive technologies to prevent their leakage to the other participant. In a long-standing alliance between General Electric and Snecma to build commercial aircraft engines for single-aisle commercial jet aircraft, for example, GE reduced the risk of excess transfer by walling off certain sections of the production process. The modularization effectively cut off the transfer of what GE regarded as key competitive technology, while permitting Snecma access to final assembly. Formed in 1974, the alliance has been remarkably successful, and today it dominates the market for jet engines used on the Boeing 737 and Airbus 320.[54] Similarly, in the alliance between Boeing and the Japanese to build the 767, Boeing walled off research, design, and marketing functions considered central to its competitive position, while allowing the Japanese to share in production technology. Boeing also walled off new technologies not required for 767 production.[55]

Second, contractual safeguards can be written into an alliance agreement to guard against the risk of opportunism by a partner. (Opportunism includes the theft of technology and/or markets.) For example, TRW, Inc., has three strategic alliances with large Japanese auto component suppliers to produce seat belts, engine valves, and steering gears for sale to Japanese-owned auto assembly plants in the United States. TRW has clauses in each of its alliance contracts that bar the Japanese firms from competing with TRW to supply U.S.-owned auto companies with component parts. By doing this, TRW protects itself against the possibility that the Japanese companies are entering into the alliances merely to gain access to the North American market to compete with TRW in its home market.

Third, both parties to an alliance can agree in advance to swap skills and technologies that the other covets, thereby ensuring a chance for equitable gain. Cross-licensing agreements are one way to achieve this goal. Fourth, the risk of opportunism by an alliance partner can be reduced if the firm extracts a significant credible commitment from its partner in advance. The long-term alliance between Xerox and Fuji to build photocopiers for the Asian market perhaps best illustrates this. Rather than enter into an informal agreement or a licensing arrangement (which Fuji Photo initially wanted), Xerox insisted that Fuji invest in a 50/50 joint venture to serve Japan and East Asia. This venture constituted such a significant investment in people, equipment, and facilities that Fuji Photo was committed from the outset to making the alliance work in order to

earn a return on its investment. By agreeing to the joint venture, Fuji essentially made a credible commitment to the alliance. Given this, Xerox felt secure in transferring its photocopier technology to Fuji.[56]

Managing the Alliance

Once a partner has been selected and an appropriate alliance structure has been agreed on, the task facing the firm is to maximize its benefits from the alliance. As in all international business deals, an important factor is sensitivity to cultural differences (see Chapter 4). Many differences in management style are attributable to cultural differences, and managers need to make allowances for these in dealing with their partner. Beyond this, maximizing the benefits from an alliance seems to involve building trust between partners and learning from partners.[57]

Managing an alliance successfully requires building interpersonal relationships between the firms' managers, or what is sometimes referred to as *relational capital*.[58] This is one lesson that can be drawn from a successful strategic alliance between Ford and Mazda. Ford and Mazda set up a framework of meetings within which their managers not only discuss matters pertaining to the alliance but also have time to get to know each other better. The belief is that the resulting friendships help build trust and facilitate harmonious relations between the two firms. Personal relationships also foster an informal management network between the firms. This network can then be used to help solve problems arising in more formal contexts (such as in joint committee meetings between personnel from the two firms).

Academics have argued that a major determinant of how much acquiring knowledge a company gains from an alliance is its ability to learn from its alliance partner.[59] For example, in a five-year study of 15 strategic alliances between major multinationals, Gary Hamel, Yves Doz, and C. K. Prahalad focused on a number of alliances between Japanese companies and Western (European or American) partners.[60] In every case in which a Japanese company emerged from an alliance stronger than its Western partner, the Japanese company had made a greater effort to learn. Few Western companies studied seemed to want to learn from their Japanese partners. They tended to regard the alliance purely as a cost-sharing or risk-sharing device, rather than as an opportunity to learn how a potential competitor does business.

Consider the alliance between General Motors and Toyota constituted in 1985 to build the Chevrolet Nova. This alliance was structured as a formal joint venture, called New United Motor Manufacturing, Inc., and each party had a 50 percent equity stake. The venture owned an auto plant in Fremont, California. According to one Japanese manager, Toyota quickly achieved most of its objectives from the alliance: "We learned about U.S. supply and transportation. And we got the confidence to manage U.S. workers."[61] All that knowledge was then transferred to Georgetown, Kentucky, where Toyota opened its own plant in 1988. Possibly all GM got was a new product, the Chevrolet Nova. Some GM managers complained that the knowledge they gained through the alliance with Toyota has never been put to good use inside GM. They believe they should have been kept together as a team to educate GM's engineers and workers about the Japanese system. Instead, they were dispersed to various GM subsidiaries.

To maximize the learning benefits of an alliance, a firm must try to learn from its partner and then apply the knowledge within its own organization. It has been suggested that all operating employees should be well briefed on the partner's strengths and weaknesses and should understand how acquiring particular skills will bolster their firm's competitive position. Hamel, Doz, and Prahalad note that this is already standard practice among Japanese companies. They made this observation:

> We accompanied a Japanese development engineer on a tour through a partner's factory. This engineer dutifully took notes on plant layout, the number of production stages, the rate at which the line was running, and the number of employees. He recorded all this

despite the fact that he had no manufacturing responsibility in his own company, and that the alliance did not encompass joint manufacturing. Such dedication greatly enhances learning.[62]

For such learning to be of value, it must be diffused throughout the organization (as was seemingly not the case at GM after the GM–Toyota joint venture). To achieve this, the managers involved in the alliance should educate their colleagues about the skills of the alliance partner.

CHAPTER SUMMARY

The chapter made the following points:

1. Basic entry decisions include identifying which markets to enter, when to enter those markets, and on what scale.
2. The most attractive foreign markets tend to be found in politically stable developed and developing nations that have free market systems and where there is not a dramatic upsurge in either inflation rates or private-sector debt.
3. There are several advantages associated with entering a national market early, before other international businesses have established themselves. These advantages must be balanced against the pioneering costs that early entrants often have to bear, including the greater risk of business failure.
4. Large-scale entry into a national market constitutes a major strategic commitment that is likely to change the nature of competition in that market and limit the entrant's future strategic flexibility. Although making major strategic commitments can yield many benefits, there are also risks associated with such a strategy.
5. There are six modes of entering a foreign market: exporting, creating turnkey projects, licensing, franchising, establishing joint ventures, and setting up a wholly owned subsidiary.
6. Exporting has the advantages of facilitating the realization of experience curve economies and of avoiding the costs of setting up manufacturing operations in another country. Disadvantages include high transport costs, trade barriers, and problems with local marketing agents.
7. Turnkey projects allow firms to export their process know-how to countries where FDI might be prohibited, thereby enabling the firm to earn a greater return from this asset. The disadvantage is that the firm may inadvertently create efficient global competitors in the process.
8. The main advantage of licensing is that the licensee bears the costs and risks of opening a foreign market. Disadvantages include the risk of losing technological know-how to the licensee and a lack of tight control over licensees.
9. The main advantage of franchising is that the franchisee bears the costs and risks of opening a foreign market. Disadvantages center on problems of quality control of distant franchisees.
10. Joint ventures have the advantages of sharing the costs and risks of opening a foreign market and of gaining local knowledge and political influence. Disadvantages include the risk of losing control over technology and a lack of tight control.
11. The advantages of wholly owned subsidiaries include tight control over technological know-how. The main disadvantage is that the firm must bear all the costs and risks of opening a foreign market.
12. The optimal choice of entry mode depends on the firm's strategy. When technological know-how constitutes a firm's core competence, wholly owned subsidiaries are preferred, since they best control technology. When management know-how constitutes a firm's core competence, foreign franchises controlled by joint ventures seem to be optimal. When the firm is pursuing a global standardization or transnational strategy, the need for tight control over

operations to realize location and experience curve economies suggests wholly owned subsidiaries are the best entry mode.

13. When establishing a wholly owned subsidiary in a country, a firm must decide whether to do so by a greenfield venture strategy or by acquiring an established enterprise in the target market.
14. Acquisitions are quick to execute, may enable a firm to preempt its global competitors, and involve buying a known revenue and profit stream. Acquisitions may fail when the acquiring firm overpays for the target, when the cultures of the acquiring and acquired firms clash, when there is a high level of management attrition after the acquisition, and when there is a failure to integrate the operations of the acquiring and acquired firm.
15. The advantage of a greenfield venture in a foreign country is that it gives the firm a much greater ability to build the kind of subsidiary company that it wants. For example, it is much easier to build an organization culture from scratch than it is to change the culture of an acquired unit.
16. Strategic alliances are cooperative agreements between actual or potential competitors. The advantage of alliances are that they facilitate entry into foreign markets, enable partners to share the fixed costs and risks associated with new products and processes, facilitate the transfer of complementary skills between companies, and help firms establish technical standards.
17. The disadvantage of a strategic alliance is that the firm risks giving away technological know-how and market access to its alliance partner.
18. The disadvantages associated with alliances can be reduced if the firm selects partners carefully, paying close attention to the firm's reputation and the structure of the alliance so as to avoid unintended transfers of know-how.
19. Two keys to making alliances work seem to be building trust and informal communications networks between partners and taking proactive steps to learn from alliance partners.

Critical Thinking and Discussion Questions

1. Review the Management Focus on Tesco. Then answer the following questions:
   a. Why did Tesco's initial international expansion strategy focus on developing nations?
   b. How does Tesco create value in its international operations?
   c. In Asia, Tesco has a history of entering into joint-venture agreements with local partners. What are the benefits of doing this for Tesco? What are the risks? How are those risks mitigated?
   d. In March 2006 Tesco announced it would enter the United States. This represents a departure from its historic strategy of focusing on developing nations. Why do you think Tesco made this decision? How is the U.S. market different from others Tesco has entered? What are the risks here? How do you think Tesco will do?
2. Licensing proprietary technology to foreign competitors is the best way to give up a firm's competitive advantage. Discuss.
3. Discuss how the need for control over foreign operations varies with firms' strategies and core competencies. What are the implications for the choice of entry mode?
4. A small Canadian firm that has developed valuable new medical products using its unique biotechnology know-how is trying to decide how best to serve the European Union market. Its choices are given below. The cost of investment in manufacturing facilities will be a major one for the Canadian firm, but it is not outside its reach. If these are the firm's only options, which one would you advise it to choose? Why?
   - Manufacture the products at home and let foreign sales agents handle marketing.
   - Manufacture the products at home and set up a wholly owned subsidiary in Europe to handle marketing.
   - Enter into an alliance with a large European pharmaceutical firm. The products would be manufactured in Europe by the 50/50 joint venture and marketed by the European firm.

Research Task globalEDGE globaledge.msu.edu

Entry Strategy and Strategic Alliances

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

A vital element in a successful international market entry strategy is an appropriate fit of skills and capabilities between partners. As such, the *Entrepreneur* magazine annually publishes a ranking of the "Top Global Franchises." Provide a list of the top 10 companies that pursue franchising as a mode of international expansion. Study one of these companies in detail and provide a description of its business model, its international expansion pattern, desirable qualifications in possible franchisees, and the support and training typically provided by the franchiser. Are there areas where improvement can be made for the company to maintain competitiveness? Provide sufficient justification for your position.

Exercise 2

The U.S. Commercial Service prepares reports known as the "*Country Commercial Guide*" for countries of interest to U.S. investors. Utilize the Country Commercial Guide for Russia to gather information on this country's energy and mining industry. Considering that your company has plans to enter Russia in the foreseeable future, select the most appropriate entry method. Be sure to support your decision with the information collected.

CLOSING CASE

General Electric's Joint Ventures

Historically at General Electric, if you wanted to enter a foreign market, you either acquired an established firm in that market or you went alone, establishing a greenfield subsidiary. Joint ventures with a local company were almost never considered. The prevailing philosophy was that if GE didn't have full control, you didn't do the deal. However, times have changed. Since the early 2000s joint ventures have become one of the most powerful strategic tools in GE's arsenal. To enter the South Korean market, for example, GE Money, the retail lending arm of GE's financial services business, formed joint ventures with Hyundai to offer auto loans, mortgages, and credit cards. GE has a 43 percent stake in these ventures. Similarly, in Spain it has formed several joint ventures with local banks to provide consumer loans and credit cards to Spanish residents, and in Central America it has a joint venture with BAC-Credomatic, the largest bank in the region.

There are several reasons for the switch in strategy. For one thing, GE used to be able to buy its way into majority ownership in almost any business, but prices for acquisitions have been bid so high that GE is reluctant to acquire for fear of overpaying. Better to form a joint venture, so the thinking goes, than risk paying too much for a company that turns out to have problems that are discovered only after the acquisition. Just as importantly, GE now sees joint ventures as a great way to dip its toe into foreign markets where it lacks local knowledge. Also, in certain nations, China being an example, economic, political, legal, and cultural considerations make joint ventures an easier option than either acquisitions or greenfield ventures. GE believes it can often benefit from the political contacts, local expertise, and business relationships that the local partner brings to the table, to say nothing of the fact that in certain sectors of the Chinese economy and some others, local laws prohibit other entry modes. GE also sees joint ventures as a good way to share the risk of building a business in a nation where it lacks local knowledge. Finally, under the leadership of CEO Jeffrey Immelt, GE has adopted aggressive growth goals, and it feels that entering via joint ventures into nations where it lacks a presence is the only way of attaining these goals. Fueled by its large number of joint ventures, GE has rapidly expanded its international presence over the past decade. For the first time, in 2007 the company derived the majority of its revenue from foreign operations.

Of course, General Electric has done joint ventures in the past. For example, it has a long-standing 50-50 joint venture with the French company Snecma to make engines for commercial jet aircraft, another with Fanuc of Japan to make controls for electrical equipment, and

a third with Sea Containers of the United Kingdom, which has become one of the world's largest companies leasing shipping containers. But all of these ventures came about only after GE had explored other ways to gain access to particular markets or technology. While GE formerly used joint ventures as the last option, they are now often the preferred entry strategy.

GE managers also note that there is no shortage of partners willing to enter into a joint venture with the company. The company has a well-earned reputation for being a good partner to work with. GE is well known for its innovative management techniques and excellent management development programs. Many partners are only too happy to team up with GE to get access to this know-how. The knowledge flow, therefore, goes both ways, with GE acquiring access to knowledge about local markets, and partners learning cutting-edge management techniques from GE that can be used to boost their own productivity.

Nevertheless, joint ventures are no panacea. GE's agreements normally give even the minority partner in a joint venture veto power over major strategic decisions, and control issues can scuttle some ventures. In January 2007, for example, GE announced it would enter into a venture with Britain's Smiths Group to make aerospace equipment. However, nine months later, GE ended talks aimed at establishing the venture, stating they could not reach an agreement over the vision for the joint venture. GE has also found that as much as it would like majority ownership, or even a 50/50 split, sometimes it has to settle for a minority stake to gain access to a foreign market. In 2003, when GE entered into a joint venture with Hyundai to offer auto loans, it did so as a minority partner even though it would have preferred a majority position. Hyundai had refused to cede control over to GE.[63]

Case Discussion Questions

1. GE used to prefer acquisitions or greenfield ventures as an entry mode rather than joint ventures. Why do you think this was the case?
2. Why do you think that GE has come to prefer joint ventures in recent years? Do you think that the global economic crisis of 2008–2009 might have affected this preference in any way? If so, how?
3. What are the risks that GE must assume when it enters into a joint venture? Is there any way for GE to reduce these risks?
4. The case mentions that GE has a well-earned reputation for being a good partner. What are the likely benefits of this reputation to GE? If GE were to tarnish its reputation by, for example, opportunistically taking advantage of a partner, how might this impact the company going forward?
5. In addition to its reputation for being a good partner, what other assets do you think GE brings to the table that make it an attractive joint-venture partner?

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IKEA 521

Coca-Cola

Coca-Cola, the iconic American soda maker, has long been among the most international of enterprises. The company made its first move outside the United States in 1902, when it entered Cuba. By 1929, Coke was marketed in 76 countries. In World War II, Coca-Cola struck a deal to supply the U.S. military with Coca-Cola wherever in the world it went. During this era, the company built 63 bottling plants around the world. Its global push continued after the war, fueled in part by the belief that the U.S. market would eventually reach maturity and by the perception that huge growth opportunities lay overseas. Today more than 59,000 of the company's 71,000 employees are located in 200 countries outside of the United States, and over 70 percent of Coca-Cola's case volume is in international markets.

Until the 1980s, Coca-Cola's strategy was one of considerable localization. Local operations were granted a high degree of independence to manage their own operations. This all changed in the 1980s and 1990s under the leadership of Roberto Goizueta, a talented Cuban immigrant who became the CEO in 1981. Goizueta placed renewed emphasis on the company's flagship brands, which were extended with the introduction of Diet Coke, Cherry Coke, and the like. His prime belief was that the main difference between the United States and international markets was the lower level of penetration in the latter, where consumption per capita of colas was only 10 to 15 percent of the U.S. figure. Goizueta pushed Coca-Cola to become a global company, centralizing a great deal of management and marketing activities at the corporate headquarters in Atlanta, focusing on core brands, and taking equity stakes in foreign bottlers so that the company could exert more strategic control over them. This one-size-fits-all strategy was built around standardization and the realization of economies of scale by, for example, using the same advertising message worldwide.

Goizueta's global strategy was adopted by his successor, Douglas Ivester, but by the late 1990s the drive toward a one-size-fits-all strategy was running out of steam, as smaller more nimble local competitors marketing local beverages began to halt the Coke growth engine. With Coca-Cola failing to hit its financial targets for the first time in a generation, Ivester resigned in 2000 and was replaced by Douglas Daft. Daft instituted a 180-degree shift in strategy. Daft's belief was that Coca-Cola needed to put more power back in the hands of local country managers. He thought that strategy, product development, and marketing should be tailored to local needs. He laid off 6,000 employees, many of them in Atlanta, and granted country managers much greater autonomy. In a striking move for a marketing company, he announced the company would stop making global advertisements, and he placed advertising budgets and control over creative content back in the hands of country managers. Ivester's move was in part influenced by the experience of Coca-Cola in Japan, the company's second most profitable market, where the best-selling Coca-Cola product is not a carbonated beverage, but a canned cold coffee drink, Georgia, that is sold in vending machines. The Japanese experience seemed to signal that products should be customized to local tastes and preferences, and that Coca-Cola would do well to decentralize more decision-making authority to local managers.

However, the shift toward localization didn't produce the growth that had been expected, and by 2002 the pendulum was swinging back toward more central coordination, with Atlanta exercising oversight over marketing and product development in different nations. But this time it was not the one-size-fits-all ethos of the Goizueta era. Under the leadership of Neville Isdell, who became CEO in March 2004 and retired in July 2008, Coca-Cola reviewed and guided local marketing and product development but adopted the belief that strategy, including pricing, product offerings, and marketing message, should be varied from market to market to match local conditions. Isdell's position represented a midpoint between the strategy of Goizueta and that of Daft. Moreover, Isdell stressed the importance of leveraging good ideas across nations. An example is Georgia coffee. Having seen the success of this beverage in Japan, in October 2007 Coca-Cola entered into a strategic alliance with Illycaffe, one of Italy's premier coffee makers, to build a global franchise for canned or bottled cold coffee beverages. Similarly, in 2003 the Coca-Cola subsidiary in China developed a low-cost noncarbonated orange-based drink that rapidly became one of the best-selling drinks in that nation. Seeing the potential of the drink, Coca-Cola rolled it out in other Asian countries. It has been a huge hit in Thailand, where it was launched in 2005, and seems to be gaining traction in India, where it was launched in 2007.[1]

Case Discussion Questions

1. Why do you think that Roberto Goizueta switched from a strategy that emphasized localization toward one that empathized global standardization? What were the benefits of such a strategy?
2. What were the limitations of Goizueta's strategy that persuaded his successor, Daft, to shift away from it? What was Daft trying to achieve? Daft's strategy also did not produce the desired results. Why do you think this was the case?

3. How would you characterize the strategy pursued by Coca-Cola under Isdell's leadership? What is the enterprise trying to do? How is this different from the strategies of both Goizueta and Daft? What are the benefits? What are the potential costs and risk?
4. What does the evolution of Coca-Cola's strategy tell you about the convergence of consumer tastes and preference in today's global economy?

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Diebold

For much of its 144-year history, Diebold Inc. did not worry much about international business. As a premier name in bank vaults and then automated teller machines (ATMs), the Ohio-based company found that it had its hands full focusing on U.S. financial institutions. By the 1970s and 1980s, the company's growth was been driven by the rapid acceptance of ATM machines in the United States. The company first started to sell ATM machines in foreign markets in the 1980s. Wary of going it alone, Diebold forged a distribution agreement with the large Dutch multinational electronics company Philips. Under the agreement, Diebold manufactured ATMs in the United States and exported them to foreign customers after Philips had made the sale.

In 1990, Diebold pulled out of the agreement with Philips and established a joint venture with IBM, Interbold, for the research, development, and distribution of ATM machines worldwide. Diebold, which owned a 70 percent stake in the joint venture, supplied the machines, while IBM supplied the global marketing, sales, and service functions. Diebold established a joint venture rather than setting up its own international distribution system because the company believed it lacked the resources to establish an international presence. In essence, Diebold was exporting its machines via IBM's distribution network. Diebold's switch from Philips to IBM as a distribution partner was driven by a belief that IBM would pursue ATM sales more aggressively.

By 1997, foreign sales had grown from the single digits to more than 20 percent of Diebold's total revenues. While sales in the United States were slowing due to a saturated domestic market, Diebold was seeing rapid growth in demand for ATMs in a wide range of developed and developing markets. Particularly enticing were countries such as China, India, and Brazil, where an emerging middle class was starting to use the banking system in large numbers and demand for ATMs was expected to surge. It was at this point that Diebold decided to take the plunge and establish its own foreign distribution network.

As a first step, Diebold purchased IBM's 30 percent stake in the Interbold joint venture. In part, the acquisition was driven by Diebold's dissatisfaction with IBM's sales efforts, which often fell short of quota. Part of the problem was that for IBM's sales force, Diebold's ATMs were just part of their product portfolio and not necessarily their top priority. Diebold felt that it could attain a greater market share if it gained direct control over distribution. The company also felt that during the prior 15 years it had accumulated enough international business expertise to warrant going it alone.

Diebold's managers decided that in addition to local distribution, they would need a local manufacturing presence in a number of regions. Among the reasons for this were local differences in the way ATMs are used, which required customization of the product. In parts of Asia, for example, many customers pay their utility bills with cash via ATMs. To gain market share Diebold had to design ATMs that both accept and count stacks of up to 100 currency notes, and weed out counterfeits. In other countries, ATMs perform multiple functions from filing tax returns to distributing theater tickets. Diebold believed that locating manufacturing close to key markets would help facilitate local customization and drive forward sales.

To jump-start its international expansion, Diebold went on a foreign acquisition binge. In 1999 it acquired Brazil's Procomp Amazonia Industria Electronica, a Latin American electronics company with sales of $400 million and a big presence in ATMs. This was followed in quick succession by the acquisitions of the ATM units of France's Groupe Bull and Holland's Getronics, both major players in Europe, for a combined $160 million. In China, where no substantial indigenous competitors were open to acquisition, Diebold established a manufacturing and distribution joint venture in which it took a majority ownership position. The result; by 2002 Diebold had a manufacturing presence in Asia, Europe, and Latin America as well as the United States and distribution operations in some 80 nations; the majority of these operations were wholly owned by Diebold. International sales accounted for some 41 percent of the company's $2.11 billion in revenues in 2003 and were forecasted to grow at double-digit rates.

Interestingly, the acquisition of Brazil's Procomp also took Diebold into a new and potentially lucrative global

business. In addition to its ATM business, Procomp had an electronic voting machine business. In 1999 Procomp won a $105 million contract, the largest in Diebold's history, to outfit Brazilian polling stations with electronic voting terminals. Diebold's management realized that this might become a large global business. In 2001, Diebold expanded its presence in the electronic voting business by acquiring Global Election Systems Inc., a U.S. company that provides electronic voting technology for states and countries that want to upgrade from traditional voting technology. By 2003, Diebold was the global leader in the emerging global market for electronic voting machines, with sales of over $100 million.[1]

Case Discussion Question

1. Before 1997, Diebold manufactured its ATM machines in the United States and sold them internationally via distribution agreements, first with Philips Electronics NV and then with IBM. Why do you think Diebold choose this mode of expanding internationally? What were the advantages and disadvantages of this arrangement?
2. What do you think prompted Diebold to alter its international expansion strategy in 1997 and start setting up wholly owned subsidiaries in most markets? Why do you think the company favored acquisitions as an entry mode?
3. Diebold entered China via a joint venture, as opposed to a wholly owned subsidiary. Why do you think it did this?
4. Is Diebold pursuing a global standardization strategy or a localization strategy? Do you think this choice of strategy has affected its choice of entry mode? How?

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JCB in India

In 1979, JCB, the large British manufacturer of construction equipment, entered into a joint venture with Escorts, an Indian engineering conglomerate, to manufacture backhoe loaders for sale in India. Escorts held a majority 60 percent stake in the venture, and JCB 40 percent. The joint venture was a first for JCB, which historically had exported as much as two-thirds of its production from Britain to a wide range of nations. However, high tariff barriers made direct exports to India difficult.

JCB would probably have preferred to go it alone in India, but government regulations at the time required foreign investors to create joint ventures with local companies. JCB believed the Indian construction market was ripe for growth and could become very large. The company's managers believed that it was better to get a foothold in the nation, thereby gaining an advantage over global competitors, rather than wait until the growth potential was realized.

Twenty years later, the joint venture was selling some 2,000 backhoes in India, and had an 80 percent share of the Indian market. After years of deregulation, the Indian economy was booming. However, JCB felt that the joint venture limited its ability to expand. For one thing, much of JCB's global success was based upon the utilization of leading-edge manufacturing technologies and relentless product innovation, but the company was very hesitant about transferring this know-how to a venture where it did not have a majority stake and therefore lacked control. The last thing JCB wanted was for these valuable technologies to leak out of the joint venture into Escorts, which was one of the largest manufacturers of tractors in India and might conceivably become a direct competitor in the future. Moreover, JCB was unwilling to make the investment in India required to take the joint venture to the next level unless it could capture more of the long-run returns. Accordingly, in 1999 JCB took advantages of changes in government regulations to renegotiate the terms of the venture with Escorts, purchasing 20 percent of its partner's equity to give JCB majority control. In 2002, JCB took this to its logical end when it responded to further relaxation of government regulations on foreign investment to purchase all of Escorts' remaining equity, transforming the joint venture into a wholly owned subsidiary. Around the same time, JCB also invested in wholly owned factories in the United States and Brazil.

Having gained full control, in early 2005 JCB increased its investment in India, announcing it would build a second factory that it would use to serve the fast-growing Indian market. At the same time, JCB also announced it would set up another wholly owned factory in China to serve that market. India and China, the two most populous nations in the world, were growing rapidly, construction was booming, and JCB, then the

world's fifth-largest manufacturer of construction equipment, was eager to expand its presence to match its global rivals, particularly Caterpillar, Komatsu, and Volvo, which were also expanding aggressively in these markets. By 2008 there were signs that JCB's foreign investment was bearing fruit. The product line had been expanded from 120 machines in 2001 to over 250. JCB had 47 dealers and some 275 outlets around India, and it claimed a market share in India of 53 percent. JCB's sales approached £1.8 billion, earnings were a record £187 million, and the company had moved up to No. 4 in the industry with almost 10 percent of global market share.[1]

Case Discussion Questions

1. What was the strategic rational underlying JCB's entry into India in 1979 and China in 2005? Given that capital to fund expansion is limited, does it make more sense for JCB to expand its presence in these markets, as opposed to more developed markets, such as those of Western Europe?
2. Why do you think JCB chose to enter India via a joint venture, as opposed to some other entry mode?
3. Why did JCB not simply license its technology to Escorts?
4. What were the potential disadvantages of JCB's joint venture with Escorts?
5. What were the benefits of gaining full control of the Indian joint venture in 2002? Can you think of any drawbacks?

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IKEA: Furniture Retailer to the World

INTRODUCTION

IKEA is one of the world's most successful global retailers. In 2007, IKEA had 300 home furnishing superstores stores in 35 countries and was visited by some 583 million shoppers. IKEA's low-priced, elegantly designed merchandise, displayed in large warehouse stores, generated sales of €21.2 billion in 2008, up from €4.4 billion in 1994. Although the privately held company refuses to publish figures on profitability, its net profit margins were rumored to be about 10 percent, high for a retailer. The founder, Ingvar Kamprad, now in his 80s but still an active adviser to the company, is rumored to be one of the world's richest men.

COMPANY BACKGROUND

IKEA was established by Ingvar Kamprad in Sweden in 1943 when he was just 17 years old. The fledgling company sold fish, Christmas magazines, and seeds from his family farm. It wasn't his first business; that had been selling matches, which the enterprising Kamprad had purchased wholesale in 100-box lots (with help from his grandmother who financed the enterprise) and then resold individually at a higher markup. The name IKEA was an acronym, I and K being his initials, while E stood for Elmtaryd, the name of the family farm, and A stood for Agunnaryd, the name of the village in southern Sweden where the farm was located. Before long Kamprad had added ballpoint pens to his list and was selling his products via mail order. His warehouse was a shed on the family farm. The customer fulfillment system utilized the local milk truck, which picked up goods daily and took them to the train station.

In 1948 Kamprad added furniture to his product line, and in 1949 he published his first catalog, distributed then as now for free. In 1953 Kamprad found himself struggling with another problem; the milk truck had changed its route and he could no longer use it to take goods to the train station. Kamprad's solution was to buy an idle factory in nearby Almhult and convert it into his warehouse. With business now growing rapidly, Kamprad hired a 22-year-old designer, Gillis Lundgren. Lundgren originally helped Kamprad to do photo shoots for the early IKEA catalogs, but over time he started to design more and more furniture for IKEA, eventually designing as many as 400 pieces, including many best sellers.

IKEA's goal as it emerged over time was to provide stylish functional designs with minimalist lines that could be manufactured cost efficiently under contract by suppliers and priced low enough to allow most people to afford them. Kamprad's theory was that "good furniture could be priced so that the man with that flat wallet would make a place for it in his spending and could afford it."[1] Kamprad was struck by the fact that furniture in Sweden was expensive at the time, something that he attributed to a fragmented industry dominated by small retailers. Furniture was also often considered a family

[1] Quoted in R. Heller, "Folk Fortune," *Forbes*, September 4, 2000, p. 67.

heirloom, passed down across the generations. He wanted to change this: to make it possible for people of modest means to buy their own furniture. Ultimately, this led to the concept of what IKEA calls "democratic design"—a design that, according to Kamprad, "was not just good, but also from the start adapted to machine production and thus cheap to assemble."[2] Gillis Lundgren was instrumental in the implementation of this concept. Time and time again he would find ways to alter the design of furniture to save on manufacturing costs.

Lundgren also stumbled on what was to become a key feature of IKEA furniture: self-assembly. Trying to efficiently pack and ship a long-legged table, he hit upon the idea of taking the legs off and mailing them packed flat under the tabletop. Kamprad quickly noticed that flat-packed furniture reduced transport and warehouse costs and also reduced damage (IKEA had been having a lot of problems with furniture damaged during the shipping process). Also, customers seemed willing to take on the task of assembly in return for lower prices. By 1956, self-assembly was integral to the IKEA concept.

In 1957 IKEA started to exhibit and sell its products at home furnishing fairs in Sweden. By cutting retailers out of the equation and using the self-assembly concept, Kamprad could undercut the prices of established retail outlets, much to their chagrin. Established retailers responded by prohibiting IKEA from taking orders at the annual furniture trade show in Stockholm. Established outlets claimed that IKEA was imitating their designs. This was to no avail, however, so the retailers went further, pressuring furniture manufacturers not to sell to IKEA. This had two unintended consequences. First, without access to the designs of many manufacturers, IKEA was forced to design more of its products in-house. Second, Kamprad looked for a manufacturer that would produce the IKEA-designed furniture. Ultimately he found one in Poland.

To his delight, Kamprad discovered that furniture manufactured in Poland was as much as 50 percent cheaper than furniture made in Sweden, allowing him to cut prices even further. Kamprad also found that doing business with the Poles required the consumption of considerable amounts of vodka to celebrate business transactions, and for the next 40 years his drinking was legendary. Alcohol consumption apart, the relationship that IKEA established with the Poles was to become the archetype for future relationships with suppliers. According to one of the Polish managers, there were three advantages to doing business with IKEA: "One concerned the decision making; it was always one man's decision, and you could rely upon what had been decided. We were given long-term contracts, and were able to plan in peace and quiet. . . . A third advantage was that IKEA introduced new technology. One revolution, for instance, was a way of treating the surface of wood. They also mastered the ability to recognize cost savings that could trim the price."[3] By the early 1960s, Polish-made goods were to be found on over half of the pages of the IKEA catalog.

By 1958, an expanded facility at the Almhult location became the first IKEA store. The original idea behind the store was to have a location where customers could come and see IKEA furniture set up. It was a supplement to IKEA's main mail order business, but it very quickly became an important sales point. The store soon started to sell car roof racks so that customers could leave with flat-packed furniture loaded on top. Noticing that a trip to an IKEA store was something of an outing for many shoppers (Almhult was not a major population center, and people often drove in from long distances), Kamprad experimented with adding a restaurant to the Almhult store so that customers could relax and refresh themselves while shopping. The restaurant was a hit and it became an integral feature of all IKEA stores.

The response of IKEA's competitors to its success was to argue that IKEA products were of low quality. In 1964, just after 800,000 IKEA catalogs had been mailed to Swedish homes, the widely read Swedish magazine *Allt i Hemmet* (Everything for the Home) published a comparison of IKEA furniture to that sold in traditional Swedish retailers. The furniture was tested for quality in a Swedish design laboratory. The magazine's analysis, detailed in a 16-page spread, was that not only was IKEA's quality as good as if not better than that of other Swedish furniture manufacturers, but also the prices were much lower. For example, the magazine concluded that a chair bought at IKEA for 33 kroner ($4) was better than a virtually identical one bought in a more expensive store for 168 kroner ($21). The magazine also showed how a living room furnished with IKEA products was as much as 65 percent less expensive than one furnished with equivalent products from four other stores. This publicity made IKEA acceptable in middle-class households, and sales began to take off.

In 1965, IKEA opened its first store in Stockholm, Sweden's capital. By now, IKEA was generating the equivalent of €25 million and had already opened a store in neighboring Norway. The Stockholm store, its third, was the largest furniture store in Europe and had an innovative circular design that was modeled on the famous Guggenheim Art Museum in New York. The location of the store was to set the pattern at IKEA for decades. The store was situated on the outskirts of the city, rather than downtown, and there was ample space for parking and good access roads. The new store generated a large

[2] B. Torekull, *Leading by Design: The IKEA Story* (New York: Harper Collins, 1998), p. 53.

[3] Ibid., pp. 61–62.

amount of traffic, so much so that employees could not keep up with customer orders, and long lines formed at the checkouts and merchandise pickup areas. To try to reduce the lines, IKEA experimented with a self-service pickup solution, allowing shoppers to enter the warehouse, load flat-packed furniture onto trolleys, and then take them through the checkout. It was so successful that this soon became the company norm in all stores.

INTERNATIONAL EXPANSION

By 1973 IKEA was the largest furniture retailer in Scandinavia with nine stores. The company enjoyed a market share of 15 percent in Sweden. Kamprad, however, felt that growth opportunities were limited. Starting with a single store in Switzerland, the company expanded rapidly in Western Europe during the next 15 years. IKEA met with considerable success, particularly in West Germany where it had 15 stores by the late 1980s. As in Scandinavia, Western European furniture markets were largely fragmented and served by high-cost retailers located in expensive downtown stores and selling relatively expensive furniture that was not always immediately available for delivery. IKEA's elegant functional designs with their clean lines, low prices, and immediate availability were a breath of fresh air, as was the self-service store format. The company was met with almost universal success even though, as one former manager put it: "We made every mistake in the book, but money nevertheless poured in. We lived frugally, drinking now and again, yes perhaps too much, but we were on our feet bright and cheery when the doors were open for the first customers, competing in good Ikean spirit for the cheapest solutions."[4]

The man in charge of the European expansion was Jan Aulino, Kamprad's former assistant, who was just 34 years old when the expansion started. Aulino surrounded himself with a young team. Aulino recalled that the expansion was so fast paced that the stores were rarely ready when IKEA moved in. Moreover, it was hard to get capital out of Sweden due to capital controls, so the trick was to make a quick profit and get a positive cash flow going as soon as possible. In the haste to expand, Aulino and his team did not always pay attention to detail, and he reportedly clashed with Kamprad on several occasions and considered himself fired at least four times, although he never was. Eventually the European business was reorganized and tighter controls were introduced.

IKEA was slow to expand in the United Kingdom, however, where the locally grown company Habitat had built a business that was similar in many respects to IKEA, offering stylish furniture at a relatively low price. IKEA also entered North America, opening seven stores in Canada between 1976 and 1982. Emboldened by this success, in 1985 the company entered the United States. It proved to be a challenge of an entirely different nature.

On the face of it, America looked to be fertile territory for IKEA. As in Western Europe, furniture retailing was a very fragmented business in the United States. At the low end of the market were the general discount retailers, such as Walmart, Costco, and Office Depot, which sold a limited product line of basic furniture, often at a very low price. This furniture was very functional, lacked the design elegance associated with IKEA, and was generally of a fairly low quality. Then there were higher-end retailers, such as Ethan Allen, which offered high-quality, well-designed, and high-priced furniture. They sold this furniture in full-service stores staffed by knowledgeable sales people. High-end retailers would often sell ancillary services as well, such as interior design. Typically these retailers would offer home delivery service, including setup in the home, either for free or for a small additional charge. Since it was expensive to keep large inventories of high-end furniture, much of what was on display in stores was not readily available, and the client would often have to wait a few weeks before it was delivered.

IKEA opened its first U.S. store in 1985 in Philadelphia. The company had decided to locate on the coasts. Surveys of American consumers suggested that IKEA buyers were more likely to be people who had travelled abroad, who considered themselves risk takers, and who liked fine food and wine. These people were concentrated on the coasts. As one manager put it, "There are more Buicks driven in the middle than on the coasts."[5]

Although IKEA initially garnered favorable reviews and enough sales to persuade it to start opening additional stores, by the early 1990s it was clear that things were not going well in America. The company found that its European-style offerings didn't always resonate with American consumers. Beds were measured in centimeters, not the king, queen, and twin sizes with which Americans are familiar. American sheets didn't fit on IKEA beds. Sofas weren't big enough, wardrobe drawers were not deep enough, glasses were too small, curtains too short, and kitchens didn't fit U.S. size appliances. In a story often repeated at IKEA, managers noted that customers were buying glass vases and using them to drink out of, rather than the small glasses for sale at IKEA. The glasses were apparently too small for Americans who like to add liberal quantities of ice to their drinks. To make matters worse, IKEA was sourcing

[4] Ibid., p. 109.

[5] J. Leland, "How the Disposable Sofa Conquered America," *The New York Times Magazine*, October 5, 2005, p. 45.

many of the goods from overseas and they were priced in Swedish kroner, which was strengthening against the U.S. dollar. This drove up the price of goods in IKEA's American stores. Also, some of the stores were poorly located, and the stores were not large enough to offer the full IKEA experience familiar to Europeans.

Turning around its American operations required IKEA to take some decisive actions. Many products had to be redesigned to fit with American needs. Newer and larger store locations were chosen. To bring prices down, goods were sourced from lower-cost locations and priced in dollars. IKEA also started to source some products from factories in the United States to reduce both transport costs and dependency on the value of the dollar. At the same time, IKEA was noticing a change in American culture. Americans were becoming more concerned with design and more open to the idea of disposable furniture. It used to be said that Americans changed their spouses about as often as they changed their dinning room table, about 1.5 times in a lifetime, but something was shifting in American culture. Younger people were more open to risks and more willing to experiment, and there was a thirst for design elegance and quality. Starbucks was tapping into this, as was Apple Computer, and so did IKEA. According to one manager at IKEA, "10 or 15 years ago, travelling in the United States, you couldn't eat well. You couldn't get good coffee. Now you can get good bread in the supermarket, and people think that is normal. I like that very much. That is more important to good life than the availability of expensive wines. That is what IKEA is about."[6]

To tap into America's shifting culture, IKEA reemphasized design, and it started promoting itself with a series of quirky hip advertisements aimed at a younger demographic—young married couples, college students, and 20- to 30-something singles. One IKEA commercial, called "Unboring," made fun of the reluctance of Americans to part with their furniture. One famous ad featured a discarded lamp, forlorn and forsaken in some rainy American city. A man turns to the camera sympathetically. "Many of you feel bad for this lamp," he says in a thick Swedish accent. "That is because you are crazy." Hip people, the commercial implied, bought furniture at IKEA. Hip people didn't hang on to their furniture either; after a while they replaced it with something else from IKEA.

The shift in tactics worked. IKEA's revenues doubled in a four-year period to $1.27 billion in 2001, up from $600 million in 1997. By 2008 the United States was IKEA's second-largest market after Germany, with 35 stores accounting for 10 percent of total revenues, or around $2.4 billion, and expansion plans called for there to be more than 50 stores in the United States by 2012.

[6] Ibid.

Having learned vital lessons about competing in foreign countries outside of continental Western Europe, IKEA continued to expand internationally in the 1990s and 2000s. It entered the United Kingdom in 1987 and by 2008 had 17 stores in the country. IKEA also acquired Britain's Habitat in the early 1990s and continued to run it under the Habitat brand name. In 1998, IKEA entered China, where it had 4 stores by 2008, followed by Russia in 2000 (11 stores by 2008), and in 2006 Japan, a country where it had failed miserably 30 years earlier (by 2008 IKEA had 4 stores in Japan). In total, by 2008 there were 285 IKEA stores in 36 countries and territories, and the company had plans to continue opening between 20 and 25 stores a year for the foreseeable future. According to one manager, an important limiting factor on the pace of expansion was building the supply network.

As with the United States, some local customization has been the order of the day. In China, for example, the store layout reflects the layout of many Chinese apartments, and since many Chinese apartments have balconies, IKEA's Chinese stores include a balcony section. IKEA also has had to adapt its locations in China, where car ownership is still not widespread. In the West, IKEA stores are generally located in suburban areas and have lots of parking space. In China, stores are located near public transportation, and IKEA offers delivery services so that Chinese customers can get their purchases home. IKEA has also adopted a deep price discounting model in China, pricing some items as much as 70 percent below their price in IKEA stores outside of China. To make this work, IKEA has sourced a large percentage of its products sold in China from local suppliers.

THE IKEA CONCEPT AND BUSINESS MODEL

IKEA's target market is the young upwardly mobile global middle class who are looking for low-priced but attractively designed furniture and household items. This group is targeted with somewhat wacky offbeat advertisements that help to drive traffic into the stores. The stores themselves are large warehouses, festooned in the blue and yellow colors of the Swedish flag, that offer 8,000 to 10,000 items from kitchen cabinets to candlesticks. There is plenty of parking outside, and the stores are located with good access to major roads.

The interior of the stores is configured almost as a maze that requires customers to pass through each department to get to the checkout. The goal is simple: to get customers to make more impulse purchases as they wander through the IKEA wonderland. Customers who enter the store planning to buy a $40 coffee table can end up spending $500 on everything from storage units to kitchenware. The flow of departments is constructed

with an eye to boosting sales. For example, when IKEA managers noticed that men would get bored while their wives stopped in the home textile department, they added a tool section just outside the textile department, and sales of tools skyrocketed. At the end of the maze, just before the checkout, is the warehouse where customers can pick up their flat-packed furniture. IKEA stores also have restaurants (located in the middle of the store) and child-care facilities (located at the entrance for easy drop-off) so that shoppers stay as long as possible.

Products are designed to reflect the clean Swedish lines that have become IKEA's trademark. IKEA has a product strategy council, which is a group of senior managers who establish priorities for IKEA's product lineup. Once a priority is established, product developers survey the competition and then set a price point that is 30 to 50 percent below that of rivals. As IKEA's website states, "We design the price tag first, then the product." Once the price tag is set, designers work with a network of suppliers to drive down the cost of producing the unit. The goal is to identify the appropriate suppliers and least costly materials, a trial-and-error process that can take as long as three years. By 2008, IKEA had 1,380 suppliers in 54 countries. The top sourcing countries were China (21 percent of supplies), Poland (17 percent), Italy (8 percent), Sweden (6 percent), and Germany (6 percent).

IKEA devotes considerable attention to finding the right supplier for each item. Consider the company's best-selling Klippan love seat. Designed in 1980, the Klippan, with its clean lines, bright colors, simple legs, and compact size, has sold some 1.5 million units since its introduction. IKEA originally manufactured the product in Sweden but soon transferred production to lower-cost suppliers in Poland. As demand for the Klippan grew, IKEA then decided it made more sense to work with suppliers in each of the company's big markets to avoid the costs associated with shipping the product all over the world. Today there are five suppliers of the frames in Europe, plus three in the United States, and two in China. To reduce the cost of the cotton slipcovers, IKEA has concentrated production in four core suppliers in China and Europe. The resulting efficiencies from these global sourcing decisions enabled IKEA to reduce the price of the Klippan by some 40 percent between 1999 and 2005.

Although IKEA contracts out manufacturing for most of its products, since the early 1990s a certain proportion of goods have been made internally (in 2008 around 90 percent of all products were sourced from independent suppliers, with 10 percent being produced internally). The integration into manufacturing was born out of the collapse of Communist governments in Eastern Europe after the fall of the Berlin Wall in 1989. By 1991 IKEA was sourcing some 25 percent of its goods from Eastern European manufacturers. It had invested considerable energy in building long-term relationships with these suppliers and had often helped them to develop and purchase new technology so that they could make IKEA products at a lower cost. As communism collapsed and new bosses came in to the factories, many did not feel bound by the relationships with IKEA. They effectively tore up contracts, tried to raise prices, and underinvested in new technology.

With its supply base at risk, IKEA purchased a Swedish manufacturer, Swedwood. IKEA then used Swedwood as the vehicle to buy and run furniture manufacturers across Eastern Europe, with the largest investments being made in Poland. IKEA invested heavily in its Swedwood plants, equipping them with the most modern technology. Beyond the obvious benefits of giving IKEA a low-cost source of supply, Swedwood has also enabled IKEA to acquire knowledge about manufacturing processes that are useful both in product design and in relationships with other suppliers, giving IKEA the ability to help suppliers adopt new technology and drive down their costs.

For illustration, consider IKEA's relationship with suppliers in Vietnam. IKEA has expanded its supply base there to help support its growing Asian presence. IKEA was attracted to Vietnam by the combination of low-cost labor and inexpensive raw materials. IKEA drives a tough bargain with its suppliers, many of whom say they make thinner margins on their sales to IKEA than they do to other foreign buyers. IKEA demands high quality at a low price. But there is an upside; IKEA offers the prospect of forging a long-term, high-volume business relationship. Moreover, IKEA regularly advises its Vietnamese suppliers on how to seek out the best and cheapest raw materials, how to set up and expand factories, what equipment to purchase, and how to boost productivity through technology investments and management process.

ORGANIZATION AND MANAGEMENT

In many ways IKEA's organization and management practices reflect the personal philosophy of its founder. A 2004 article in *Fortune* describes Kamprad, then one of the world's richest men, as an informal and frugal man who "insists on flying coach, takes the subway to work, drives a 10-year-old Volvo, and avoids suits of any kind. It has long been rumored in Sweden that when his self-discipline fails and he drinks an overpriced Coke out of a hotel mini bar, he will go down to a grocery store to buy a replacement."[7] Kamprad's thriftiness is attributed to his upbringing in Smaland, a traditionally poor region

[7] C. Daniels and A. Edstrom, "Create IKEA, Make Billions, Take a Bus," *Fortune*, May 3, 2006, p. 44.

of Sweden. Kamprad's frugality is now part of IKEA's DNA. Managers are forbidden to fly first class and expected to share hotel rooms.

Under Kamprad, IKEA became mission driven. He had a cause, and those who worked with him adopted it too. It was to make life better for the masses, to democratize furniture. Kamprad's management style was informal, nonhierarchical, and team based. Titles and privileges are taboo at IKEA. There are no special perks for senior managers. Pay is not particularly high, and people generally work there because they like the atmosphere. Suits and ties have always been absent. From the head office to the loading docks, the culture is egalitarian. Offices are open plan, furnished with IKEA furniture, and private offices are rare. Everyone is called a "co-worker," and first names are used throughout. IKEA regularly stages anti-bureaucracy weeks during which executives work on the store floor or tend to registers. In a 2005 *BusinessWeek* article the CEO, Andres Dahlvig, described how he spent time earlier in the year unloading trucks and selling beds and mattresses.[8] Creativity is highly valued, and the company is replete with stories of individuals taking the initiative, from Gillis Lundgren's pioneering of the self-assemble concept to the store manager in the Stockhom store who let customers go into the warehouse to pick up their own furniture. To solidify this culture, IKEA had a preference for hiring younger people who had not worked for other enterprises and then promoting from within. IKEA has historically tended to shy away from hiring the highly educated status-oriented elite because they often adapted poorly to the company.

Kamprad seems to have viewed his team as extended family. Back in 1957 he bankrolled a weeklong trip to Spain for all 80 employees and their families as reward for hard work. The early team of employees all lived near each other. They worked together, played together, drank together, and talked about IKEA around the clock. When asked by an academic researcher what was the fundamental key to good leadership, Kamprad replied "love." Recollecting the early days, he noted, "When we were working as a small family in Aluhult, we were as if in love. Nothing whatsoever to do with eroticism. We just liked each other so damn much."[9] Another manager noted, "We who wanted to join IKEA did so because the company suits our way of life. To escape thinking about status, grandeur, and smart clothes."[10]

As IKEA grew, the question of taking the company public arose. While there were obvious advantages associated with doing so, including access to capital, Kamprad decided against it. His belief was that the stock market would impose short-term pressures on IKEA that would not be good for the company. The constant demands to produce profits, regardless of the business cycle, would in Kamprad's view make it more difficult for IKEA to take bold decisions. At the same time, as early as 1970 Kamprad started to worry about what would happen if he died. He decided he did not want his sons to inherit the business. His worry was that they would either sell the company, or they might squabble over control of the company, and thus destroy it. All three of his sons, it should be noted, went to work at IKEA as managers.

The solution to this dilemma created one of the most unusual corporate structures in the world. In 1982 Kamprad transferred his interest in IKEA to a Dutch-based charitable foundation, Stichting Ingka Foundation. This is a tax-exempt, nonprofit entity that in turn owns Ingka Holding, a private Dutch firm that is the legal owner of IKEA. A five-person committee, chaired by Kamprad and including his wife, runs the foundation. In addition, the IKEA trademark and concept was transferred to IKEA Systems, another private Dutch company, whose parent company, Inter-IKEA, is based in Luxembourg. The Luxembourg company is in turn owned by an identically named company in the Netherlands Antilles, whose beneficial owners remain hidden from public view, but they are almost certainly the Kamprad family. Inter-IKEA earns its money from a franchise agreement it has with each IKEA store. The largest franchisee is none other than Ingka Holding. IKEA states that franchisees pay 3 percent of sales to Inter-IKEA. Thus, Kamprad has effectively moved ownership of IKEA out of Sweden, although the company's identity and headquarters remain there, and established a mechanism for transferring funds to himself and his family from the franchising of the IKEA concept. Kamprad himself moved to Switzerland in the 1980s to escape Sweden's high taxes, and he has lived there since.

In 1986, Kamprad gave up day-to-day control of IKEA to Andres Moberg, a 36-year-old Swede who had dropped out of college to join IKEA's mail order department. Despite relinquishing management control, Kamprad continued to exert influence over the company as an adviser to senior management and an ambassador for IKEA, a role he was still pursuing with vigor in 2008, despite being in his 80s.

LOOKING FORWARD

In a half century, IKEA had established an enviable position for itself. It had become one of the most successful retail establishments in the world. It had expanded into numerous foreign markets, learning from its failures and building on its successes. It had bought affordable, well-designed, functional furniture to the masses, helping

[8] K. Capell et al., "Ikea," *BusinessWeek*, November 14, 2005, pp. 96–106.
[9] Torekull, *Leading by Design: The IKEA Story*, p. 82.
[10] Ibid., p. 83.

them to, in Kamprad's words, achieve a better everyday life. IKEA's goal was to continue to grow, opening 20 to 25 stores a year for the foreseeable future. Achieving that growth would mean expansion into non-Western markets, including most notably China where it had recently established a beachhead. Could the company continue to do so? Was its competitive advantage secure?

Case Discussion Questions

1. By the early 1970s IKEA had established itself as the largest furniture retailer in Sweden. What was the source of its competitive advantage at that time?
2. Why do you think IKEA's expansion into Europe went so well? Why did the company subsequently stumble in North America? What lessons did IKEA learn from this experience? How is the company now applying these lessons?
3. How would you characterize IKEA's strategy before its missteps in North America? How would you characterize its strategy today?
4. What is IKEA's strategy toward its suppliers? How important is this strategy to IKEA's success?
5. What is the source of IKEA's success today? Can you see any weaknesses in the company? What might it do to correct these?

part six Business Operations

16 Exporting, Importing, and Countertrade

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Explain the promises and risks associated with exporting.
- **LO2** Identify the steps managers can take to improve their firm's export performance.
- **LO3** Identify information sources and government programs that exist to help exporters.
- **LO4** Recognize the basic steps involved in export financing.
- **LO5** Describe how countertrade can be used to facilitate exporting.

Vellus Products

Sharon Doherty founded Vellus Products in 1991 in Columbus, Ohio, to sell pet shampoo. Doherty's original insight was that shampoos for people don't work well on pets because the skin of most animals is more sensitive than that of humans and becomes easily irritated. A competitive dog exhibitor, she knew that most existing pet shampoo left dog hair unmanageable and lacking the glamour needed for a dog show. Working with her nephew, who had a Ph.D. in chemistry, Doherty developed salon-type formulas that were specially suited to dogs (shampoo for horses was added later).

Doherty booked Vellus's first export sales in 1993 when a Taiwanese businessman, who had picked up Vellus shampoo in the United States, ordered $25,000 worth of products he wanted to try to sell through dog shows in Taiwan. Before long, Doherty was getting calls from people around the world, most of whom heard about Vellus products at dog shows, and a thriving export business was born.

As the volume of inquiries grew, Doherty realized she needed a better understanding of foreign markets, export potential, and financing options, so she contacted the U.S. Department of Commerce's Commercial Service offices in Columbus. "As business has grown, I have gone from ordering country profiles to requesting customized exporting and financing strategies tailored to maximize export potential," she says. Today Vellus exports to 28 nations, although the bulk of the firm's international business operates through distributors in Sweden, Finland, Britain, France, Germany,



Australia, New Zealand, Canada, and Iceland, where the products are marketed at pet shows and exhibitions. The company has registered its trademark in 15 European countries, and international sales account for more than half the firm's total. "I credit the Commercial Service for helping me to expand my exports, as it would have been much more difficult on my own," says Doherty.

Reflecting on her international success, Doherty has some advice for others who might want to go down the same road. First she says, know whom you are dealing with. Relationships are important to successful exporting. Doherty says she goes out of her way to give advice and guidance to her distributors, sharing her knowledge and helping them to be successful. Second, having being duped by a man who claimed he knew the pet market, when he didn't, she advocates doing background checks on potential business partners. "Gather as much information as you can," she says. "Don't make any assumptions; the wrong choice can cost your business valuable time and money." Third, Doherty believes that it is important to learn the local culture. Vellus products are adapted to best suit different grooming techniques in different countries, something that she believes has helped to make the company more successful. Finally, Doherty says, enjoy the ride! "I love exporting because it has enabled me to meet so many people from other cultures. Exporting has made me more broad-minded, and I have developed a great appreciation for other cultures and the way others live their lives."[1]

Introduction

The previous chapter reviewed exporting from a strategic perspective. We considered exporting as just one of a range of strategic options for profiting from international expansion. This chapter is more concerned with the nuts and bolts of exporting (and importing). It looks at how to export. As the opening case makes clear, exporting is not just for large enterprises; many small entrepreneurial firms such as Vellus Products have benefited significantly from the moneymaking opportunities of exporting.

The volume of export activity in the world economy has increased as exporting has become easier. The gradual decline in trade barriers under the umbrella of GATT and now the WTO (see Chapter 7) along with regional economic agreements such as the European Union and the North American Free Trade Agreement (see Chapter 9) have significantly increased export opportunities. At the same time, modern communication and transportation technologies have alleviated the logistical problems associated with exporting. Firms are increasingly using the World Wide Web, toll-free phone numbers, and international air express services to reduce the costs of exporting. Consequently, it is not unusual to find thriving exporters among small companies.

Nevertheless, exporting remains a challenge for many firms. Smaller enterprises can find the process intimidating. The firm wishing to export must identify foreign market opportunities, avoid a host of unanticipated problems that are often associated with doing business in a foreign market, familiarize itself with the mechanics of export and import financing, learn where it can get financing and export credit insurance, and learn how it should deal with foreign exchange risk. The process can be made more problematic by currencies that are not freely convertible. Arranging payment for exports to countries with weak currencies can be a problem. Countertrade allows payment for exports to be made through goods and services rather than money. This chapter discusses all these issues with the exception of foreign exchange risk, which was covered in Chapter 10. The chapter opens by considering the promise and pitfalls of exporting.

LO1 The Promise and Pitfalls of Exporting

The great promise of exporting is that large revenue and profit opportunities are to be found in foreign markets for most firms in most industries. This was true for Vellus Products, which was profiled in the opening case. The international market is normally so much larger than the firm's domestic market that exporting is nearly always a way to increase the revenue and profit base of a company. By expanding the size of the market, exporting can enable a firm to achieve economies of scale, thereby lowering its unit costs. Firms that do not export often lose out on significant opportunities for growth and cost reduction.[2]

Consider the case of Marlin Steel Wire Products, a Baltimore manufacturer of wire baskets and fabricated metal items with revenues of about $3.5 million. Among its products are baskets to hold dedicated parts for aircraft engines and automobiles. Its engineers design custom wire baskets for the assembly lines of companies such as Boeing and Toyota. It has a reputation for producing high-quality products for these niche markets. Like many small businesses, Marlin did not have a history of exporting. However, in the mid-2000s, Marlin dipped its toe in the export market, shipping small numbers of products to Mexico and Canada. Marlin CEO Drew Greenblatt soon realized that export sales could be the key to growth. In 2008 when the global financial crisis hit and America slid into a serious recession, Marlin was exporting only 5 percent of its orders to foreign markets. Greenblatt's strategy for dealing with weak demand from the United

States was to aggressively expand its international sales. By 2010 exports accounted for 17 percent of sales, and the company has set a goal of exporting half of its output by 2014.[3]

Despite example such as Vellus Products and Marlin, studies have shown that while many large firms tend to be proactive about seeking opportunities for profitable exporting, systematically scanning foreign markets to see where the opportunities lie for leveraging their technology, products, and marketing skills in foreign countries, many medium-sized and small firms are very reactive.[4] Typically, such reactive firms do not even consider exporting until their domestic market is saturated and the emergence of excess productive capacity at home forces them to look for growth opportunities in foreign markets. Also, many small and medium-sized firms tend to wait for the world to come to them, rather than going out into the world to seek opportunities. Even when the world does come to them, they may not respond. An example is MMO Music Group, which makes sing-along tapes for karaoke machines. Foreign sales accounted for about 15 percent of MMO's revenues of $8 million, but the firm's CEO admits this figure would probably have been much higher had he paid attention to building international sales. Unanswered faxes and phone messages from Asia and Europe often piled up while he was trying to manage the burgeoning domestic side of the business. By the time MMO did turn its attention to foreign markets, other competitors had stepped into the breach and MMO found it tough going to build export volume.[5]

MMO's experience is common, and it suggests a need for firms to become more proactive about seeking export opportunities. One reason more firms are not proactive is that they are unfamiliar with foreign market opportunities; they simply do not know how big the opportunities actually are or where they might lie. Simple ignorance of the potential opportunities is a huge barrier to exporting.[6] Also, many would-be exporters, particularly smaller firms, are often intimidated by the complexities and mechanics of exporting to countries where business practices, language, culture, legal systems, and currency are very different from the home market.[7] This combination of unfamiliarity and intimidation probably explains why exporters still account for only a tiny percentage of U.S. firms, less than 5 percent of firms with fewer than 500 employees, according to the Small Business Administration.[8]

To make matters worse, many neophyte exporters run into significant problems when first trying to do business abroad and this sours them on future exporting ventures. Common pitfalls include poor market analysis, a poor understanding of competitive conditions in the foreign market, a failure to customize the product offering to the needs of foreign customers, lack of an effective distribution program, a poorly executed promotional campaign, and problems securing financing.[9] Novice exporters tend to underestimate the time and expertise needed to cultivate business in foreign countries.[10] Few realize the amount of management resources that have to be dedicated to this activity. Many foreign customers require face-to-face negotiations on their home turf. An exporter may have to spend months learning about a country's trade regulations, business practices, and more before a deal can be closed. The accompanying Management Focus, which documents the experience of FCX Systems in China, suggests that it may take years before foreigners are comfortable enough to purchase in significant quantities.

Exporters often face voluminous paperwork, complex formalities, and many potential delays and errors. According to a UN report on trade and development, a typical international trade transaction may involve 30 parties, 60 original documents, and 360 document copies, all of which have to be checked, transmitted, reentered into various information systems, processed, and filed. The United Nations has calculated that the time involved in preparing documentation, along with the costs of common errors in paperwork, often amounts to 10 percent of the final value of goods exported.[11]

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FCX Systems

Founded with the help of a $20,000 loan from the Small Business Administration, FCX Systems is an exporting success story. FCX makes power converters for the aerospace industry. These devices convert common electric utility frequencies into the higher frequencies used in aircraft systems and are primarily used to provide power to aircraft while they are on the ground. Today the West Virginia enterprise generates over half of its $20 million in annual sales from exports to more than 50 countries. FCX's prowess in opening foreign markets has earned the company several awards for export excellence, including a presidential award for achieving extraordinary growth in export sales.

FCX initially got into exporting because it found that foreigners were often more receptive to the company's products than potential American customers. According to Don Gallion, president of FCX, "In the overseas market, they were looking for a good technical product, preferably made in the U.S., but they weren't asking questions about 'How long have you been in business? Are you still going to be here tomorrow?' They were just anxious to get the product."

In 1989, shortly after it had been founded, FCX signed on with an international distribution company to help with exporting, but Gallion became disillusioned with that company, and in 1994 FCX started to handle the exporting process on its own. At the time, exports represented 12 percent of sales, but by 1997 they had jumped to more than 50 percent of the total, where they have stayed since.

In explaining the company's export success, Gallion cites a number of factors. One was the extensive assistance that FCX has received over the years from a number of federal and state agencies, including the U.S. Department of Commerce and the Development Office of West Virginia. These agencies demystified the process of exporting and provided good contacts for FCX. Finding a good local representative to help work through local regulations and customs is another critical factor, according to Gallion, who says, "A good rep will keep you out of trouble when it comes to customs and what you should and shouldn't do." Persistence is also very important, says Gallion, particularly when trying to break into markets where personal relationships are crucial, such as China.

China has been an interesting story for FCX. Recently the company has been booking $2 million to $3 million in sales to China, but it took years to get to this point. China had been on Gallion's radar screen since the early 1990s, primarily because of the country's rapid modernization and its plans to build or remodel some 179 airports between 1998 and 2008. This constituted a potentially large market opportunity for FCX, particularly compared with the United States where perhaps only three new airports would be built during the same period. Despite the scale of the opportunity, progress was very slow. The company had to identify airports and airline projects, government agencies, customers, and decision makers, as well as work through different languages—and make friends. According to Gallion, "Only after they consider you a friend will they buy a product. They believe a friend would never cheat you." To make friends in China, Gallion estimates he had to make more than 100 trips to China since the early 1990s, but now that the network has been established, it is starting to pay dividends.[12]

LO2 Improving Export Performance

Inexperienced exporters have a number of ways to gain information about foreign market opportunities and avoid common pitfalls that tend to discourage and frustrate novice exporters.[13] In this section, we look at information sources for exporters to increase their knowledge of foreign market opportunities, we consider the pros and cons of using export management companies (EMCs) to assist in the export process, and we review various exporting strategies that can increase the probability of successful exporting. We begin, however, with a look at how several nations try to help domestic firms export.

AN INTERNATIONAL COMPARISON



Mitsubishi Corporation is one of the seven largest *sogo shosha*.

LO3

One big impediment to exporting is the simple lack of knowledge of the opportunities available. Often there are many markets for a firm's product, but because they are in countries separated from the firm's home base by culture, language, distance, and time, the firm does not know of them. Identifying export opportunities is made even more complex because more than 200 countries with widely differing cultures compose the world of potential opportunities. Faced with such complexity and diversity, firms sometimes hesitate to seek export opportunities.

The way to overcome ignorance is to collect information. In Germany, one of the world's most successful exporting nations, trade associations, government agencies, and commercial banks gather information, helping small firms identify export opportunities. A similar function is provided by the Japanese Ministry of International Trade and Industry (**MITI**), which is always on the lookout for export opportunities. In addition, many Japanese firms are affiliated in some way with the ***sogo shosha***, Japan's great trading houses. The *sogo shosha* have offices all over the world, and they proactively, continuously seek export opportunities for their affiliated companies large and small.[14]

German and Japanese firms can draw on the large reservoirs of experience, skills, information, and other resources of their respective export-oriented institutions. Unlike their German and Japanese competitors, many U.S. firms are relatively blind when they seek export opportunities; they are information disadvantaged. In part, this reflects historical differences. Both Germany and Japan have long made their living as trading nations, whereas until recently the United States has been a relatively self-contained continental economy in which international trade played a minor role. This is changing; both imports and exports now play a greater role in the U.S. economy than they did 20 years ago. However, the United States has not yet evolved an institutional structure for promoting exports similar to that of either Germany or Japan.

INFORMATION SOURCES

Despite institutional disadvantages, U.S. firms can increase their awareness of export opportunities. The most comprehensive source of information is the U.S. Department of Commerce and its district offices all over the country (as noted in the opening case, Vellus Products used these services and credits them with the company's international successes). Within that department are two organizations dedicated to providing businesses with intelligence and assistance for attacking foreign markets: the International Trade Administration and the U.S. Commercial Service.

These agencies provide the potential exporter with a "best prospects" list, which gives the names and addresses of potential distributors in foreign markets along with businesses they are in, the products they handle, and their contact person. In addition, the Department of Commerce has assembled a "comparison shopping service" for 14 countries that are major markets for U.S. exports. For a small fee, a firm can receive a customized market research survey on a product of its choice. This survey provides information on marketability, the competition, comparative prices, distribution channels, and names of potential sales representatives. Each study is conducted on-site by an officer of the Department of Commerce.

The Department of Commerce also organizes trade events that help potential exporters make foreign contacts and explore export opportunities. The department organizes exhibitions at international trade fairs, which are held regularly in major cities worldwide. The department also has a matchmaker program, in which department representatives accompany groups of U.S. businesspeople abroad to meet with qualified agents, distributors, and customers.

Another government organization, the Small Business Administration (SBA), can help potential exporters (see the accompanying Management Focus for examples of the



MANAGEMENT FOCUS

Exporting with a Little Government Help

Exporting can seem like a daunting prospect, but the reality is that in the United States, as in many other countries, many small enterprises have built profitable export businesses. For example, Landmark Systems of Virginia had virtually no domestic sales before it entered the European market. Landmark had developed a software program for IBM mainframe computers and located an independent distributor in Europe to represent its product. In the first year, 80 percent of sales were attributed to exporting. In the second year, sales jumped from $100,000 to $1.4 million—with 70 percent attributable to exports. Landmark is not alone; government data suggest that in the United States over 95 percent of the 240,000 firms that export are small or medium-sized businesses that employ fewer than 500 people. Their share of total U.S. exports grew steadily and reached 29 percent by the mid-2000s.

To help jump-start the exporting process, many small companies have drawn on the expertise of government agencies, financial institutions, and export management companies. Consider the case of Novi, Inc., a California-based business. Company President Michael Stoff tells how he utilized the services of the U.S. Small Business Administration (SBA) Office of International Trade to start exporting: "When I began my business venture, Novi, Inc., I knew that my Tune-Tote (a stereo system for bicycles) had the potential to be successful in international markets. Although I had no prior experience in this area, I began researching and collecting information on international markets. I was willing to learn, and by targeting key sources for information and guidance, I was able to penetrate international markets in a short period of time. One vital source I used from the beginning was the SBA. Through the SBA I was directed to a program that dealt specifically with business development—the Service Corps of Retired Executives (SCORE). I was assigned an adviser who had run his own import/export business for 30 years. The services of SCORE are provided on a continual basis and are free.

"As I began to pursue exporting, my first step was a thorough marketing evaluation. I targeted trade shows with a good presence of international buyers. I also went to DOC (Department of Commerce) for counseling and information about the rules and regulations of exporting. I advertised my product in *Commercial News USA,* distributed through U.S. embassies to buyers worldwide. I utilized DOC's World Traders Data Reports to get background information on potential foreign buyers. As a result, I received 60 to 70 inquiries about Tune-Tote from around the world. Once I completed my research and evaluation of potential buyers, I decided which ones would be most suitable to market my product internationally. Then I decided to grant exclusive distributorship. In order to effectively communicate with my international customers, I invested in a fax. I chose a U.S. bank to handle international transactions. The bank also provided guidance on methods of payment and how best to receive and transmit money. This is essential know-how for anyone wanting to be successful in foreign markets."

In just one year of exporting, export sales at Novi topped $1 million and increased 40 percent in the second year of operations. Today, Novi, Inc., is a large distributor of wireless intercom systems that exports to more than 10 countries.[15]

SBA's work). The SBA employs 76 district international trade officers and 10 regional international trade officers throughout the United States as well as a 10-person international trade staff in Washington, D.C. Through its Service Corps of Retired Executives (SCORE) program, the SBA also oversees some 850 volunteers with international trade experience to provide one-on-one counseling to active and new-to-export businesses. The SBA also coordinates the Export Legal Assistance Network (ELAN), a nationwide group of international trade attorneys who provide free initial consultations to small businesses on export-related matters.

In addition to the Department of Commerce and SBA, nearly every state and many large cities maintain active trade commissions whose purpose is to promote exports. Most of these provide business counseling, information gathering, technical assistance,

and financing. Unfortunately, many have fallen victim to budget cuts or to turf battles for political and financial support with other export agencies.

A number of private organizations are also beginning to provide more assistance to would-be exporters. Commercial banks and major accounting firms are more willing to assist small firms in starting export operations than they were a decade ago. In addition, large multinationals that have been successful in the global arena are typically willing to discuss opportunities overseas with the owners or managers of small firms.[16]

UTILIZING EXPORT MANAGEMENT COMPANIES LO2

One way for first-time exporters to identify the opportunities associated with exporting and to avoid many of the associated pitfalls is to hire an **export management company** (EMC). EMCs are export specialists that act as the export marketing department or international department for their client firms. MD International, which we look at in the closing case, is one such enterprise. EMCs normally accept two types of export assignments. They start exporting operations for a firm with the understanding that the firm will take over operations after they are well established. In another type, start-up services are performed with the understanding that the EMC will have continuing responsibility for selling the firm's products. Many EMCs specialize in serving firms in particular industries and in particular areas of the world. Thus, one EMC may specialize in selling agricultural products in the Asian market, while another may focus on exporting electronics products to Eastern Europe. MD International, for example, focuses on selling medical equipment to Latin America.

In theory, the advantage of EMCs is that they are experienced specialists that can help the neophyte exporter identify opportunities and avoid common pitfalls. A good EMC will have a network of contacts in potential markets, have multilingual employees, have a good knowledge of different business mores, and be fully conversant with the ins and outs of the exporting process and with local business regulations. However, the quality of EMCs varies.[17] While some perform their functions very well, others appear to add little value to the exporting company. Therefore, an exporter should review carefully a number of EMCs and check references. One drawback of relying on EMCs is that the company can fail to develop its own exporting capabilities.

EXPORT STRATEGY LO2

In addition to using EMCs, a firm can reduce the risks associated with exporting if it is careful about its choice of export strategy.[18] A few guidelines can help firms improve their odds of success. For example, one of the most successful exporting firms in the world, the Minnesota Mining and Manufacturing Co. (3M), has built its export success on three main principles—enter on a small scale to reduce risks, add additional product lines once the exporting operations start to become successful, and hire locals to promote the firm's products (3M's export strategy is profiled in the accompanying Management Focus). Another successful exporter, Red Spot Paint & Varnish, emphasizes the importance of cultivating personal relationships when trying to build an export business (see the Management Focus at the end of this section).

The probability of exporting successfully can be increased dramatically by taking a handful of simple strategic steps. First, particularly for the novice exporter, it helps to hire an EMC or at least an experienced export consultant to help identify opportunities and navigate the paperwork and regulations so often involved in exporting. Second, it often makes sense to initially focus on one market or a handful of markets. Learn what is required to succeed in those markets before moving on to other markets. The firm that enters many markets at once runs the risk of spreading its limited management resources too thin. The result of such a shotgun approach to exporting may be a failure to become established in any one market. Third, as with 3M, it often makes sense to enter a foreign market on a small scale to reduce the costs of any



MANAGEMENT FOCUS

Export Strategy at 3M

The Minnesota Mining and Manufacturing Co. (3M), which makes more than 40,000 products including tape, sandpaper, medical products, and the ever-present Post-it notes, is one of the world's great multinational operations. Today over 60 percent of the firm's revenues are generated outside the United States. Although the bulk of these revenues came from foreign-based operations, 3M remains a major exporter with more than $2 billion in exports. The company often uses its exports to establish an initial presence in a foreign market, only building foreign production facilities once sales volume rises to a level that justifies local production.

The export strategy is built around simple principles. One is known as "FIDO," which stands for First In (to a new market) Defeats Others. The essence of FIDO is to gain an advantage over other exporters by getting into a market first and learning about that country and how to sell there before others do. A second principle is "make a little, sell a little," which is the idea of entering on a small scale with a very modest investment and pushing one basic product, such as reflective sheeting for traffic signs in Russia or scouring pads in Hungary. Once 3M believes it has learned enough about the market to reduce the risk of failure to reasonable levels, it adds additional products.

A third principle at 3M is to hire local employees to sell the firm's products. The company normally sets up a local sales subsidiary to handle its export activities in a country. It then staffs this subsidiary with local hires because it believes they are likely to have a much better idea of how to sell in their own country than American expatriates. Because of the implementation of this principle, fewer than 200 of 3M's 40,000 plus foreign employees are U.S. expatriates.

Another common practice at 3M is to formulate global strategic plans for the export and eventual overseas production of its products. Within the context of these plans, 3M gives local managers considerable autonomy to find the best way to sell the product within their country. Thus, when 3M first exported its Post-it notes, it planned to "sample the daylights" out of the product, but it also told local managers to find the best way of doing this. Local managers hired office cleaning crews to pass out samples in Great Britain and Germany; in Italy, office products distributors were used to pass out free samples; while in Malaysia, local managers employed young women to go from office to office handing out samples of the product. In typical 3M fashion, when the volume of Post-it notes was sufficient to justify it, exports from the United States were replaced by local production. Thus, after several years 3M found it worthwhile to set up production facilities in France to produce Post-it notes for the European market.[19]

subsequent failure. Most importantly, entering on a small scale provides the time and opportunity to learn about the foreign country before making significant capital commitments to that market. Fourth, the exporter needs to recognize the time and managerial commitment involved in building export sales and should hire additional personnel to oversee this activity. Fifth, in many countries, it is important to devote a lot of attention to building strong and enduring relationships with local distributors and/or customers (see the Management Focus on Red Spot Paint for an example). Sixth, as 3M often does, it is important to hire local personnel to help the firm establish itself in a foreign market. Local people are likely to have a much greater sense of how to do business in a given country than a manager from an exporting firm who has previously never set foot in that country. Seventh, several studies have suggested the firm needs to be proactive about seeking export opportunities.[20] Armchair exporting does not work! The world will not normally beat a pathway to your door. Finally, it is important for the exporter to retain the option of local production. Once exports reach a sufficient volume to justify cost-efficient local production, the exporting firm should consider establishing production facilities in the foreign market. Such localization helps foster good relations with the foreign country and can lead to greater market

MANAGEMENT FOCUS

Red Spot Paint & Varnish

Established in 1903 and based in Evansville, Indiana, Red Spot Paint & Varnish Company is in many ways typical of the companies that can be found in the small towns of America's heartland. The closely held company, whose CEO, Charles Storms, is the great-grandson of the founder, has 500 employees and annual sales of close to $90 million. The company's main product is paint for plastic components used in the automobile industry. Red Spot products are seen on automobile bumpers, wheel covers, grilles, headlights, instrument panels, door inserts, radio buttons, and other components. Unlike many other companies of a similar size and location, however, Red Spot has a thriving international business. International sales (which include exports and local production by licensees) now account for between 15 percent and 25 percent of revenue in any one year, and Red Spot does business in about 15 countries.

Red Spot has long had some international sales and once won an export award. To further its international business Red Spot hired a Central Michigan University professor, Bryan Williams. Williams, who was hired because of his foreign-language skills (he speaks German, Japanese, and some Chinese), was the first employee at Red Spot whose exclusive focus was international marketing and sales. His first challenge was the lack of staff skilled in the business of exporting. He found that it was difficult to build an international business without in-house expertise in the basic mechanics of exporting. According to Williams, Red Spot needed people who understood the nuts and bolts of exporting—letters of credit, payment terms, bills of lading, and so on. As might be expected for a business based in the heartland of America, no ready supply of such individuals was in the vicinity. It took Williams several years to solve this problem. Now Red Spot has a full-time staff of two who have been trained in the principles of exporting and international operations.

A second problem that Williams encountered was the clash between the quarter-to-quarter mentality that frequently pervades management practice in the United States and the long-term perspective that is often necessary to build a successful international business. Williams has found that building long-term personal relationships with potential foreign customers is often the key to getting business. When foreign customers visit Evansville, Williams often invites them home for dinner. His young children even started calling one visitor from Hong Kong "Uncle." Even with such efforts, however, the business may not come quickly. Meeting with potential foreign customers yields no direct business 90 percent of the time, although Williams points out that it often yields benefits in terms of competitive information and relationship building. He has found that perseverance pays. For example, Williams and Storms called on a major German automobile parts manufacturer for seven years before finally landing some business from the company.[21]

acceptance. Exporting is often not an end in itself, but merely a step on the road toward establishment of foreign production (again, 3M provides an example of this philosophy).

Export and Import Financing LO4

Mechanisms for financing exports and imports have evolved over the centuries in response to a problem that can be particularly acute in international trade: the lack of trust that exists when one must put faith in a stranger. In this section, we examine the financial devices that have evolved to cope with this problem in the context of international trade: the letter of credit, the draft (or bill of exchange), and the bill of lading. Then we will trace the 14 steps of a typical export–import transaction.[22]

LACK OF TRUST

Firms engaged in international trade have to trust someone they may have never seen, who lives in a different country, who speaks a different language, who abides by (or does not abide by) a different legal system, and who could be very difficult to track down if he or she defaults on an obligation. Consider a U.S. firm exporting to a distributor in France. The U.S. businessman might be concerned that if he ships the products to France before he receives payment from the French businesswoman, she might take delivery of the products and not pay him. Conversely, the French importer might worry that if she pays for the products before they are shipped, the U.S. firm might keep the money and never ship the products or might ship defective products. Neither party to the exchange completely trusts the other. This lack of trust is exacerbated by the distance between the two parties—in space, language, and culture— and by the problems of using an underdeveloped international legal system to enforce contractual obligations.

Due to the (quite reasonable) lack of trust between the two parties, each has his or her own preferences as to how the transaction should be configured. To make sure he is paid, the manager of the U.S. firm would prefer the French distributor to pay for the products before he ships them (see Figure 16.1). Alternatively, to ensure she receives the products, the French distributor would prefer not to pay for them until they arrive (see Figure 16.2). Thus, each party has a different set of preferences. Unless there is some way of establishing trust between the parties, the transaction might never occur.

The problem is solved by using a third party trusted by both—normally a reputable bank—to act as an intermediary. What happens can be summarized as follows (see Figure 16.3). First, the French importer obtains the bank's promise to pay on her behalf, knowing the U.S. exporter will trust the bank. This promise is known as a letter of credit. Having seen the letter of credit, the U.S. exporter now ships the products to France. Title to the products is given to the bank in the form of a document called a bill of lading. In return, the U.S. exporter tells the bank to pay for the products, which the bank does. The document for requesting this payment is referred to as a draft. The bank, having paid for the products, now passes the title on to the French importer, whom the bank trusts. At that time or later, depending on their agreement, the importer reimburses the bank. In the remainder of this section, we examine how this system works in more detail.

LETTER OF CREDIT

A letter of credit, abbreviated as L/C, stands at the center of international commercial transactions. Issued by a bank at the request of an importer, the **letter of credit** states that the bank will pay a specified sum of money to a beneficiary, normally the exporter, on presentation of particular, specified documents.

Consider again the example of the U.S. exporter and the French importer. The French importer applies to her local bank, say, the Bank of Paris, for the issuance of a letter of credit. The Bank of Paris then undertakes a credit check of the importer. If the Bank of Paris is satisfied with her creditworthiness, it will issue a letter of credit. However, the Bank of Paris might require a cash deposit or some other form of collateral from her first. In addition, the Bank of Paris will charge the importer a fee for this service. Typically this amounts to between 0.5 percent and 2 percent of the value of the letter of credit, depending on the importer's creditworthiness and the size of the transaction. (As a rule, the larger the transaction, the lower the percentage.)

Assume the Bank of Paris is satisfied with the French importer's creditworthiness and agrees to issue a letter of credit. The letter states that the Bank of Paris will pay the U.S. exporter for the merchandise as long as it is shipped in accordance with specified

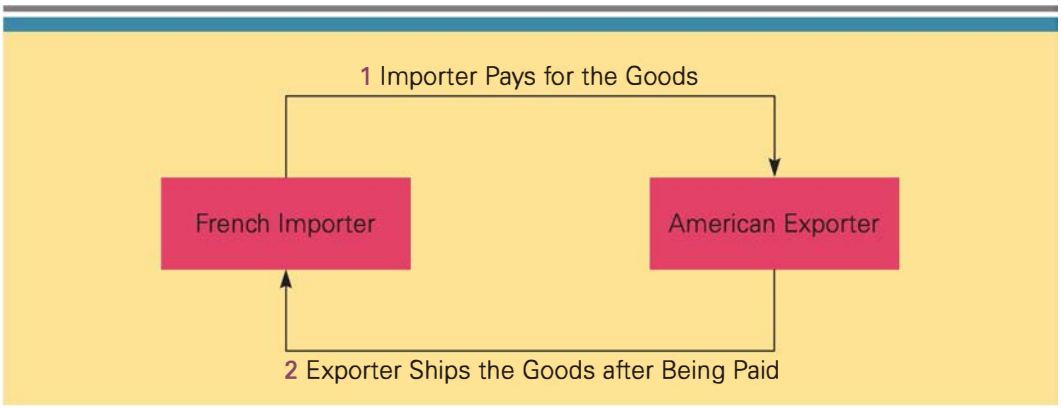

FIGURE 16.1

Preference of the U.S. Exporter



FIGURE 16.2

Preference of the French Importer

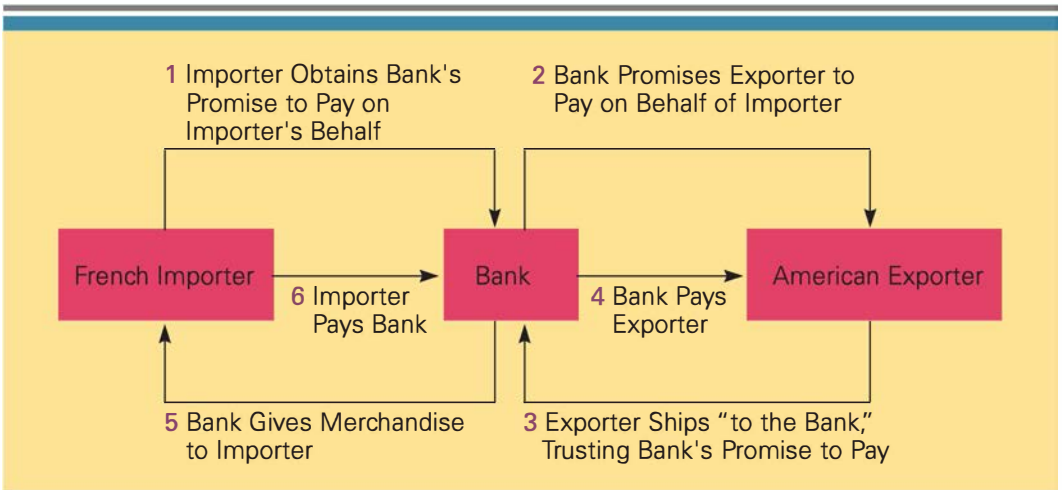

FIGURE 16.3

The Use of a Third Party

instructions and conditions. At this point, the letter of credit becomes a financial contract between the Bank of Paris and the U.S. exporter. The Bank of Paris then sends the letter of credit to the U.S. exporter's bank, say, the Bank of New York. The Bank of New York tells the exporter that it has received a letter of credit and that he can ship the merchandise. After the exporter has shipped the merchandise, he draws a draft against

the Bank of Paris in accordance with the terms of the letter of credit, attaches the required documents, and presents the draft to his own bank, the Bank of New York, for payment. The Bank of New York then forwards the letter of credit and associated documents to the Bank of Paris. If all of the terms and conditions contained in the letter of credit have been complied with, the Bank of Paris will honor the draft and will send payment to the Bank of New York. When the Bank of New York receives the funds, it will pay the U.S. exporter.

As for the Bank of Paris, once it has transferred the funds to the Bank of New York, it will collect payment from the French importer. Alternatively, the Bank of Paris may allow the importer some time to resell the merchandise before requiring payment. This is not unusual, particularly when the importer is a distributor and not the final consumer of the merchandise, since it helps the importer's cash flow. The Bank of Paris will treat such an extension of the payment period as a loan to the importer and will charge an appropriate rate of interest.

The great advantage of this system is that both the French importer and the U.S. exporter are likely to trust reputable banks, even if they do not trust each other. Once the U.S. exporter has seen a letter of credit, he knows that he is guaranteed payment and will ship the merchandise. Also, an exporter may find that having a letter of credit will facilitate obtaining preexport financing. For example, having seen the letter of credit, the Bank of New York might be willing to lend the exporter funds to process and prepare the merchandise for shipping to France. This loan may not have to be repaid until the exporter has received his payment for the merchandise. As for the French importer, she does not have to pay for the merchandise until the documents have arrived and unless all conditions stated in the letter of credit have been satisfied. The drawback for the importer is the fee she must pay the Bank of Paris for the letter of credit. In addition, since the letter of credit is a financial liability against her, it may reduce her ability to borrow funds for other purposes.

DRAFT

A draft, sometimes referred to as a **bill of exchange**, is the instrument normally used in international commerce to effect payment. A **draft** is simply an order written by an exporter instructing an importer, or an importer's agent, to pay a specified amount of money at a specified time. In the example of the U.S. exporter and the French importer, the exporter writes a draft that instructs the Bank of Paris, the French importer's agent, to pay for the merchandise shipped to France. The person or business initiating the draft is known as the maker (in this case, the U.S. exporter). The party to whom the draft is presented is known as the drawee (in this case, the Bank of Paris).

International practice is to use drafts to settle trade transactions. This differs from domestic practice in which a seller usually ships merchandise on an open account, followed by a commercial invoice that specifies the amount due and the terms of payment. In domestic transactions, the buyer can often obtain possession of the merchandise without signing a formal document acknowledging his or her obligation to pay. In contrast, due to the lack of trust in international transactions, payment or a formal promise to pay is required before the buyer can obtain the merchandise.

Drafts fall into two categories, sight drafts and time drafts. A **sight draft** is payable on presentation to the drawee. A **time draft** allows for a delay in payment—normally 30, 60, 90, or 120 days. It is presented to the drawee, who signifies acceptance of it by writing or stamping a notice of acceptance on its face. Once accepted, the time draft becomes a promise to pay by the accepting party. When a time draft is drawn on and accepted by a bank, it is called a banker's acceptance. When it is drawn on and accepted by a business firm, it is called a trade acceptance.

Time drafts are negotiable instruments; that is, once the draft is stamped with an acceptance, the maker can sell the draft to an investor at a discount from its face value. Imagine the agreement between the U.S. exporter and the French importer calls for the

exporter to present the Bank of Paris (through the Bank of New York) with a time draft requiring payment 120 days after presentation. The Bank of Paris stamps the time draft with an acceptance. Imagine further that the draft is for $100,000.

The exporter can either hold onto the accepted time draft and receive $100,000 in 120 days or he can sell it to an investor, say, the Bank of New York, for a discount from the face value. If the prevailing discount rate is 7 percent, the exporter could receive $97,700 by selling it immediately (7 percent per year discount rate for 120 days for $100,000 equals $2,300, and $100,000 − $2,300 = $97,700). The Bank of New York would then collect the full $100,000 from the Bank of Paris in 120 days. The exporter might sell the accepted time draft immediately if he needed the funds to finance merchandise in transit and/or to cover cash flow shortfalls.

BILL OF LADING

The third key document for financing international trade is the bill of lading. The **bill of lading** is issued to the exporter by the common carrier transporting the merchandise. It serves three purposes: it is a receipt, a contract, and a document of title. As a receipt, the bill of lading indicates that the carrier has received the merchandise described on the face of the document. As a contract, it specifies that the carrier is obligated to provide a transportation service in return for a certain charge. As a document of title, it can be used to obtain payment or a written promise of payment before the merchandise is released to the importer. The bill of lading can also function as collateral against which funds may be advanced to the exporter by its local bank before or during shipment and before final payment by the importer.

A TYPICAL INTERNATIONAL TRADE TRANSACTION

Now that we have reviewed the elements of an international trade transaction, let us see how the process works in a typical case, sticking with the example of the U.S. exporter and the French importer. The typical transaction involves 14 steps (see Figure 16.4).

1. The French importer places an order with the U.S. exporter and asks the American if he would be willing to ship under a letter of credit.
2. The U.S. exporter agrees to ship under a letter of credit and specifies relevant information such as prices and delivery terms.
3. The French importer applies to the Bank of Paris for a letter of credit to be issued in favor of the U.S. exporter for the merchandise the importer wishes to buy.
4. The Bank of Paris issues a letter of credit in the French importer's favor and sends it to the U.S. exporter's bank, the Bank of New York.
5. The Bank of New York advises the exporter of the opening of a letter of credit in his favor.
6. The U.S. exporter ships the goods to the French importer on a common carrier. An official of the carrier gives the exporter a bill of lading.
7. The U.S. exporter presents a 90-day time draft drawn on the Bank of Paris in accordance with its letter of credit and the bill of lading to the Bank of New York. The exporter endorses the bill of lading so title to the goods is transferred to the Bank of New York.
8. The Bank of New York sends the draft and bill of lading to the Bank of Paris. The Bank of Paris accepts the draft, taking possession of the documents and promising to pay the now-accepted draft in 90 days.
9. The Bank of Paris returns the accepted draft to the Bank of New York.
10. The Bank of New York tells the U.S. exporter that it has received the accepted bank draft, which is payable in 90 days.

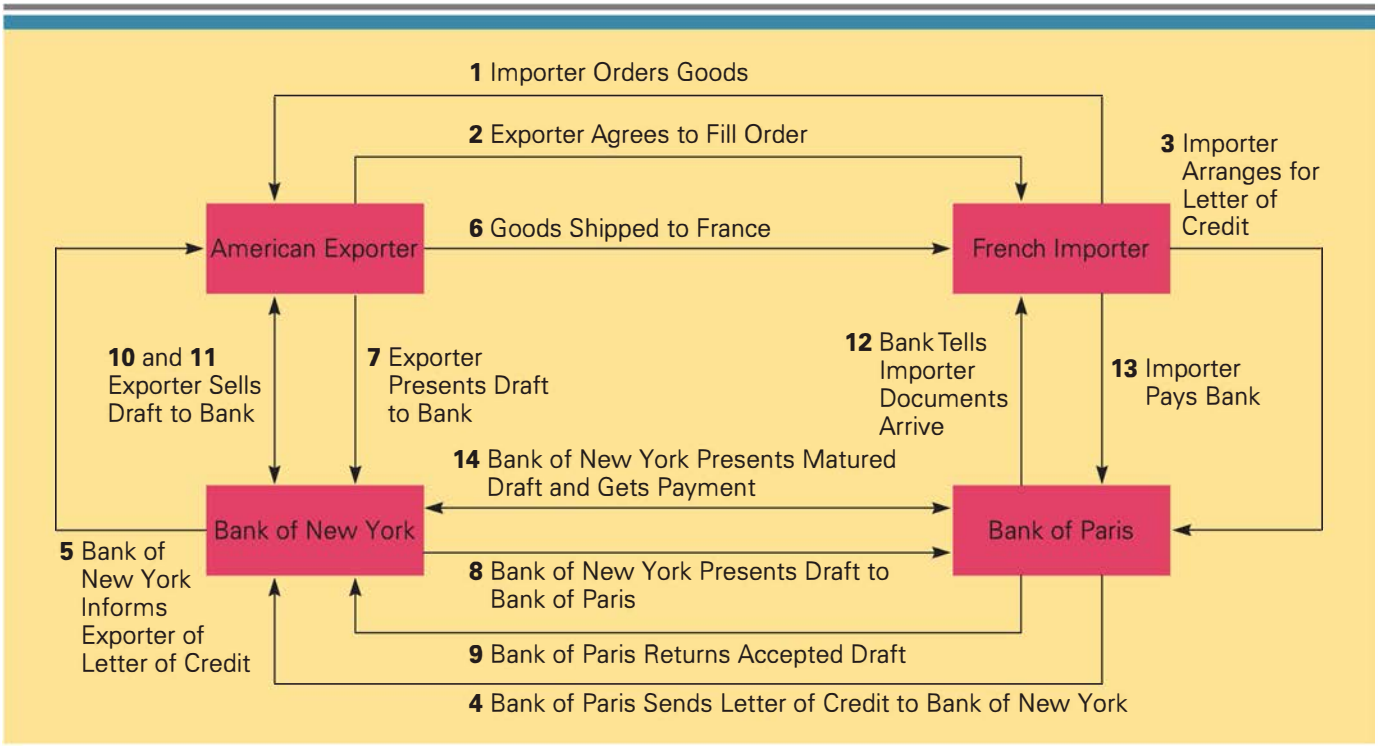

FIGURE 16.4

A Typical International Trade Transaction

11. The exporter sells the draft to the Bank of New York at a discount from its face value and receives the discounted cash value of the draft in return.
12. The Bank of Paris notifies the French importer of the arrival of the documents. She agrees to pay the Bank of Paris in 90 days. The Bank of Paris releases the documents so the importer can take possession of the shipment.
13. In 90 days, the Bank of Paris receives the importer's payment, so it has funds to pay the maturing draft.
14. In 90 days, the holder of the matured acceptance (in this case, the Bank of New York) presents it to the Bank of Paris for payment. The Bank of Paris pays.

LO3 Export Assistance

Prospective U.S. exporters can draw on two forms of government-backed assistance to help finance their export programs. They can get financing aid from the Export–Import Bank and export credit insurance from the Foreign Credit Insurance Association (similar programs are available in most countries).

EXPORT–IMPORT BANK

The **Export–Import Bank**, often referred to as Ex-Im Bank, is an independent agency of the U.S. government. Its mission is to provide financing aid that will facilitate exports, imports, and the exchange of commodities between the United States and other countries. In 2010 its financing activities were expanded from $4 billion to $6 billion following a push by the Obama administration to try to create some 2 million new jobs through exports. Ex-Im Bank pursues its mission with various loan and loan-guarantee programs. The agency guarantees repayment of medium- and long-term loans U.S. commercial



The Export–Import Bank provides financial aid to companies that require assistance with imports, exports, and the exchange of commodities.

banks make to foreign borrowers for purchasing U.S. exports. The Ex-Im Bank guarantee makes the commercial banks more willing to lend cash to foreign enterprises.

Ex-Im Bank also has a direct lending operation under which it lends dollars to foreign borrowers for use in purchasing U.S. exports. In some cases, it grants loans that commercial banks would not if it sees a potential benefit to the United States in doing so. The foreign borrowers use the loans to pay U.S. suppliers and repay the loan to Ex-Im Bank with interest.

EXPORT CREDIT INSURANCE

For reasons outlined earlier, exporters clearly prefer to get letters of credit from importers. However, sometimes an exporter who insists on a letter of credit will lose an order to one who does not require a letter of credit. Thus, when the importer is in a strong bargaining position and able to play competing suppliers against each other, an exporter may have to forgo a letter of credit.[23] The lack of a letter of credit exposes the exporter to the risk that the foreign importer will default on payment. The exporter can insure against this possibility by buying export credit insurance. If the customer defaults, the insurance firm will cover a major portion of the loss.

In the United States, export credit insurance is provided by the Foreign Credit Insurance Association (FCIA), an association of private commercial institutions operating under the guidance of the Export–Import Bank. The FCIA provides coverage against commercial risks and political risks. Losses due to commercial risk result from the buyer's insolvency or payment default. Political losses arise from actions of governments that are beyond the control of either buyer or seller. Marlin, the small Baltimore manufacturer of wire baskets discussed earlier, credits export credit insurance with giving the company the confidence to push ahead with export sales. For a premium of roughly half a percent of the price of a sale, Marlin has been able to insure itself against the possibility of nonpayment by a foreign buyer.[24]

ountertrade

LO5

Countertrade is an alternative means of structuring an international sale when conventional means of payment are difficult, costly, or nonexistent. We first encountered countertrade in Chapter 10's discussion of currency convertibility. A government may restrict

the convertibility of its currency to preserve its foreign exchange reserves so they can be used to service international debt commitments and purchase crucial imports.[25] This is problematic for exporters. Nonconvertibility implies that the exporter may not be paid in his or her home currency, and few exporters would desire payment in a currency that is not convertible. Countertrade is a common solution.[26] **Countertrade** denotes a whole range of barterlike agreements; its principle is to trade goods and services for other goods and services when they cannot be traded for money. Some examples of countertrade are:

- An Italian company that manufactures power-generating equipment, ABB SAE Sadelmi SpA, was awarded a 720 million baht ($17.7 million) contract by the Electricity Generating Authority of Thailand. The contract specified that the company had to accept 218 million baht ($5.4 million) of Thai farm products as part of the payment.
- Saudi Arabia agreed to buy 10 747 jets from Boeing with payment in crude oil, discounted at 10 percent below posted world oil prices.
- General Electric won a contract for a $150 million electric generator project in Romania by agreeing to market $150 million of Romanian products in markets to which Romania did not have access.
- The Venezuelan government negotiated a contract with Caterpillar under which Venezuela would trade 350,000 tons of iron ore for Caterpillar earthmoving equipment.
- Albania offered such items as spring water, tomato juice, and chrome ore in exchange for a $60 million fertilizer and methanol complex.
- Philip Morris ships cigarettes to Russia, for which it receives chemicals that can be used to make fertilizer. Philip Morris ships the chemicals to China, and in return, China ships glassware to North America for retail sale by Philip Morris.[27]

THE INCIDENCE OF COUNTERTRADE

In the modern era, countertrade arose in the 1960s as a way for the Soviet Union and the Communist states of Eastern Europe, whose currencies were generally nonconvertible, to purchase imports. During the 1980s, the technique grew in popularity among many developing nations that lacked the foreign exchange reserves required to purchase necessary imports. Today, reflecting their own shortages of foreign exchange reserves, some successor states to the former Soviet Union and the Eastern European Communist nations periodically engage in countertrade to purchase their imports. Estimates of the percentage of world trade covered by some sort of countertrade agreement range from highs of 8 and 10 percent by value to lows of around 2 percent.[28] The precise figure is unknown but it is probably at the low end of these estimates given the increasing liquidity of international financial markets and wider currency convertibility. However, a short-term spike in the volume of countertrade can follow periodic financial crisis. For example, countertrade activity increased notably after the Asian financial crisis of 1997. That crisis left many Asian nations with little hard currency to finance international trade. In the tight monetary regime that followed the crisis in 1997, many Asian firms found it very difficult to get access to export credits to finance their own international trade. Thus they turned to the only option available to them—countertrade.

Given that countertrade is a means of financing international trade, albeit a relatively minor one, prospective exporters may have to engage in this technique from time to time to gain access to certain international markets. The governments of developing nations sometimes insist on a certain amount of countertrade.[29] For example, all foreign companies contracted by Thai state agencies for work costing more than 500 million baht ($12.3 million) are required to accept at least 30 percent of their payment in Thai agricultural products. Between 1994 and mid-1998, foreign firms purchased 21 billion baht ($517 million) in Thai goods under countertrade deals.[30]

TYPES OF COUNTERTRADE

With its roots in the simple trading of goods and services for other goods and services, countertrade has evolved into a diverse set of activities that can be categorized as five distinct types of trading arrangements: barter, counterpurchase, offset, switch trading, and compensation or buyback.[31] Many countertrade deals involve not just one arrangement, but elements of two or more.

Barter

Barter is the direct exchange of goods and/or services between two parties without a cash transaction. Although barter is the simplest arrangement, it is not common. Its problems are twofold. First, if goods are not exchanged simultaneously, one party ends up financing the other for a period. Second, firms engaged in barter run the risk of having to accept goods they do not want, cannot use, or have difficulty reselling at a reasonable price. For these reasons, barter is viewed as the most restrictive countertrade arrangement. It is primarily used for one-time-only deals in transactions with trading partners who are not creditworthy or trustworthy.

Counterpurchase

Counterpurchase is a reciprocal buying agreement. It occurs when a firm agrees to purchase a certain amount of materials back from a country to which a sale is made. Suppose a U.S. firm sells some products to China. China pays the U.S. firm in dollars, but in exchange, the U.S. firm agrees to spend some of its proceeds from the sale on textiles produced by China. Thus, although China must draw on its foreign exchange reserves to pay the U.S. firm, it knows it will receive some of those dollars back because of the counterpurchase agreement. In one counterpurchase agreement, Rolls-Royce sold jet parts to Finland. As part of the deal, Rolls-Royce agreed to use some of the proceeds from the sale to purchase Finnish-manufactured TV sets that it would then sell in Great Britain.

Offset

An **offset** is similar to a counterpurchase insofar as one party agrees to purchase goods and services with a specified percentage of the proceeds from the original sale. The difference is that this party can fulfill the obligation with any firm in the country to which the sale is being made. From an exporter's perspective, this is more attractive than a straight counterpurchase agreement because it gives the exporter greater flexibility to choose the goods that it wishes to purchase.

Switch Trading

The term **switch trading** refers to the use of a specialized third-party trading house in a countertrade arrangement. When a firm enters a counterpurchase or offset agreement with a country, it often ends up with what are called counterpurchase credits, which can be used to purchase goods from that country. Switch trading occurs when a third-party trading house buys the firm's counterpurchase credits and sells them to another firm that can better use them. For example, a U.S. firm concludes a counterpurchase agreement with Poland for which it receives some number of counterpurchase credits for purchasing Polish goods. The U.S. firm cannot use and does not want any Polish goods, however, so it sells the credits to a third-party trading house at a discount. The trading house finds a firm that can use the credits and sells them at a profit.

In one example of switch trading, Poland and Greece had a counterpurchase agreement that called for Poland to buy the same U.S.-dollar value of goods from Greece that it sold to Greece. However, Poland could not find enough Greek goods that it required, so it ended up with a dollar-denominated counterpurchase balance in Greece that it was unwilling to use. A switch trader bought the right to 250,000 counterpurchase dollars from Poland for $225,000 and sold them to a European sultana (grape) merchant for $235,000, who used them to purchase sultanas from Greece.

Compensation or Buybacks

A **buyback** occurs when a firm builds a plant in a country—or supplies technology, equipment, training, or other services to the country—and agrees to take a certain percentage of the plant's output as partial payment for the contract. For example, Occidental Petroleum negotiated a deal with Russia under which Occidental would build several ammonia plants in Russia and as partial payment receive ammonia over a 20-year period.

THE PROS AND CONS OF COUNTERTRADE

Countertrade's main attraction is that it can give a firm a way to finance an export deal when other means are not available. Given the problems that many developing nations have in raising the foreign exchange necessary to pay for imports, countertrade may be the only option available when doing business in these countries. Even when countertrade is not the only option for structuring an export transaction, many countries prefer countertrade to cash deals. Thus, if a firm is unwilling to enter a countertrade agreement, it may lose an export opportunity to a competitor that is willing to make a countertrade agreement.

In addition, a countertrade agreement may be required by the government of a country to which a firm is exporting goods or services. Boeing often has to agree to counterpurchase agreements to capture orders for its commercial jet aircraft. For example, in exchange for gaining an order from Air India, Boeing may be required to purchase certain component parts, such as aircraft doors, from an Indian company. Taking this one step further, Boeing can use its willingness to enter into a counterpurchase agreement as a way of winning orders in the face of intense competition from its global rival, Airbus Industrie. Thus, countertrade can become a strategic marketing weapon.

However, the drawbacks of countertrade agreements are substantial. Other things being equal, firms would normally prefer to be paid in hard currency. Countertrade contracts may involve the exchange of unusable or poor-quality goods that the firm cannot dispose of profitably. For example, a few years ago, one U.S. firm got burned when 50 percent of the television sets it received in a countertrade agreement with Hungary were defective and could not be sold. In addition, even if the goods it receives are of high quality, the firm still needs to dispose of them profitably. To do this, countertrade requires the firm to invest in an in-house trading department dedicated to arranging and managing countertrade deals. This can be expensive and time-consuming.

Given these drawbacks, countertrade is most attractive to large, diverse multinational enterprises that can use their worldwide network of contacts to dispose of goods acquired in countertrading. The masters of countertrade are Japan's giant trading firms, the *sogo shosha*, which use their vast networks of affiliated companies to profitably dispose of goods acquired through countertrade agreements. The trading firm of Mitsui & Company, for example, has about 120 affiliated companies in almost every sector of the manufacturing and service industries. If one of Mitsui's affiliates receives goods in a countertrade agreement that it cannot consume, Mitsui & Company will normally be able to find another affiliate that can profitably use them. Firms affiliated with one of Japan's *sogo shosha* often have a competitive advantage in countries where countertrade agreements are preferred.

Western firms that are large, diverse, and have a global reach (e.g., General Electric, Philip Morris, and 3M) have similar profit advantages from countertrade agreements. Indeed, 3M has established its own trading company—3M Global Trading, Inc.—to develop and manage the company's international countertrade programs. Unless there is no alternative, small and medium-sized exporters should probably try to avoid countertrade deals because they lack the worldwide network of operations that may be required to profitably utilize or dispose of goods acquired through them.[32]

CHAPTER SUMMARY

This chapter examined the steps that firms must take to establish themselves as exporters. The chapter made the following points:

1. One big impediment to exporting is ignorance of foreign market opportunities.
2. Neophyte exporters often become discouraged or frustrated with the exporting process because they encounter many problems, delays, and pitfalls.
3. The way to overcome ignorance is to gather information. In the United States, a number of institutions, the most important of which is the Department of Commerce, can help firms gather information in the matchmaking process. Export management companies can also help identify export opportunities.
4. Many of the pitfalls associated with exporting can be avoided if a company hires an experienced export management company, or export consultant, and if it adopts the appropriate export strategy.
5. Firms engaged in international trade must do business with people they cannot trust and people who may be difficult to track down if they default on an obligation. Due to the lack of trust, each party to an international transaction has a different set of preferences regarding the configuration of the transaction.
6. The problems arising from lack of trust between exporters and importers can be solved by using a third party that is trusted by both, normally a reputable bank.
7. A letter of credit is issued by a bank at the request of an importer. It states that the bank promises to pay a beneficiary, normally the exporter, on presentation of documents specified in the letter.
8. A draft is the instrument normally used in international commerce to effect payment. It is an order written by an exporter instructing an importer, or an importer's agent, to pay a specified amount of money at a specified time.
9. Drafts are either sight drafts or time drafts. Time drafts are negotiable instruments.
10. A bill of lading is issued to the exporter by the common carrier transporting the merchandise. It serves as a receipt, a contract, and a document of title.
11. U.S. exporters can draw on two types of government-backed assistance to help finance their exports: loans from the Export–Import Bank and export credit insurance from the FCIA.
12. Countertrade includes a range of barterlike agreements. It is primarily used when a firm exports to a country whose currency is not freely convertible and may lack the foreign exchange reserves required to purchase the imports.
13. The main attraction of countertrade is that it gives a firm a way to finance an export deal when other means are not available. A firm that insists on being paid in hard currency may be at a competitive disadvantage vis-à-vis one that is willing to engage in countertrade.
14. The main disadvantage of countertrade is that the firm may receive unusable or poor-quality goods that cannot be disposed of profitably.

Critical Thinking and Discussion Questions

1. A firm based in Washington State wants to export a shipload of finished lumber to the Philippines. The would-be importer cannot get sufficient credit from domestic sources to pay for the shipment but insists that the finished lumber can quickly be resold in the Philippines for a profit. Outline the steps the exporter should take to effect this export to the Philippines.
2. You are the assistant to the CEO of a small textile firm that manufactures quality, premium-priced, stylish clothing. The CEO has decided to see what the opportunities are for exporting and has asked you for advice as to the steps the company should take. What advice would you give the CEO?
3. An alternative to using a letter of credit is export credit insurance. What are the advantages and

disadvantages of using export credit insurance rather than a letter of credit for exporting *(a)* a luxury yacht from California to Canada, and *(b)* machine tools from New York to Ukraine?

4. How do you explain the use of countertrade? Under what scenarios might its use increase further by 2015? Under what scenarios might its use decline?
5. How might a company make strategic use of countertrade schemes as a marketing weapon to generate export revenues? What are the risks associated with pursuing such a strategy?

Research Task globalEDGE globaledge.msu.edu

Exporting, Importing, and Countertrade

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

Exporting is an important way for small and large companies to introduce products and develop new markets. In fact, the Internet is rich with resources that offer guidance to companies wishing to expand their markets through exporting. The trade tutorials at the globalEDGE website provide links to these resources. Identify five sources and provide a description of the services available for new exporters through each source.

Exercise 2

Understanding the specific terminology used in the import/export process is necessary prior to your company's first international venture. Utilize the globalEDGE *Glossary of International Business Terms* to identify the definitions of the following terms related to exporting and importing: ad valorem tariff, consignment, embargo, global quota, invisible barriers to trade, letter of credit, mercantilism, and section 201.

CLOSING CASE

MD International

Al Merritt founded MD International in 1987. A former salesman for a medical equipment company, Merritt saw an opportunity to act as an export intermediary for medical equipment manufacturers in the United States. He chose to focus on Latin America and the Caribbean, a region that he already had experience in. Also, trade barriers were starting to fall throughout the region as Latin governments embraced a more liberal economic ideology, creating an opening for entrepreneurs such as Merritt. Local governments were also expanding their spending on health care, creating an opportunity that Merritt was poised to exploit.

Merritt located his company in south Florida to be close to his market. Since then, the company has grown to become the largest intermediary exporting medical devices to the region. Today the company sells the products of more than 30 medical manufacturers to some 600 regional distributors. While many medical equipment manufacturers don't sell directly to the region because of the sizable marketing costs, MD can afford to because it goes into those markets with a broad portfolio of products.

The company's success is in part due to its deep-rooted knowledge and understanding of the Latin American market. MD works very closely with teams of doctors, biomedical engineers, microbiologists, and marketing managers across Latin America to understand their needs and what the company can do for them. The sale of products to customers is typically only the beginning of a relationship. MD International also provides training to medical personnel in the use of devices and extensive after-sale service and support.

Along the way to becoming a successful exporter, MD International has leaned heavily upon export assistance programs established by the U.S. government. For example, in the early 2000s a shipment to Venezuela was

held up by the Venezuelan customs seeking proof that the medical devices were not intended for military use. Within two days, staff at the U.S. Export Assistance Center in Miami arranged for the U.S. embassy in Venezuela to have a letter written and delivered to the customs officials, assuring them that the products had no military applications, and the shipment was released. Merritt has also worked extensively with the Export–Import Bank to gain financing for its exports (the company needs to finance the inventory that it exports).

Despite these advantages, it has not all been easy going for MD International. Latin American economies have often been highly cyclical, and MD International has ridden those cycles with them. In 2001, for example, after several years of solid growth, an economic crisis in both Argentina and Brazil, coupled with a slowdown in Mexico, resulted in losses for the year and forced Merritt to lay off one-third of his staff and cut the pay of others, which included a 50 percent pay cut for himself. Things started to improve in 2002, and the weak dollar in the mid-2000s also helped to boost export sales. However, the global financial crisis of 2008 ushered in another tough period; although prior experience suggests that MD International can not only survive such downturns, but also come out stronger as weaker competitors fall by the wayside.[33]

Case Discussion Questions

1. How does an intermediary such as MD International create value for the manufacturers that use it to sell medical equipment in foreign markets? Why do they want to use MD International rather than export directly themselves?
2. Why did MD International focus on Latin America? What are the benefits of this regional approach? What are the potential drawbacks?
3. What would it take for MD International to start exporting to other regions such as Asia or Europe? Given this, would you advise Al Merritt to continue his regional focus going forward or to add other regions?
4. How important has government assistance been to MD International? Do you think helping firms such as MD International represents good use of taxpayer money?

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17 Global Production, Outsourcing, and Logistics

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Explain why production and logistics decisions are of central importance to many multinational businesses.
- **LO2** Explain how country differences, production technology, and product features all affect the choice of where to locate production activities.
- **LO3** Recognize how the role of foreign subsidiaries in production can be enhanced over time as they accumulate knowledge.
- **LO4** Identify the factors that influence a firm's decision of whether to source supplies from within the company or from foreign suppliers.
- **LO5** Describe what is required to efficiently coordinate a globally dispersed production system.

Making the Amazon Kindle

When online retailer Amazon.com invented its revolutionary e-book reader, the Kindle, the company had to decide where to have it made. Guiding the decision was an understanding that if the Kindle was going to be successful, it had to have that magic combination of low prices, high functionality, high reliability, and design elegance. Over time this has only become more important as competitors have emerged. These have included Sony with various readers, Barnes & Noble with its Nook, and most notably, Apple with its multipurpose iPad, which can function as a digital reader among other things. Amazon's goal has been to aggressively reduce the price of the Kindle so that it both has an edge over competitors and it becomes feasible to have a couple lying around the house as a sort of digital library.

Amazon designed the Kindle in a lab in California, precisely because this is where the key R&D expertise was located. One of the Kindle's key components, the "ink" (the tiny microcapsule beads used in its display) were designed and are made by E Ink, a company based in Cambridge, Massachusetts. Much of the rest of the value of the Kindle, however, is outsourced to manufacturing enterprises in Asia.

The market research firm iSuppli estimates that when it was introduced in 2009, the total manufacturing cost for the Kindle 2 ran about $185. The most expensive single component was the display, which cost about $60. Although the display used E Ink's technology, there were no American firms with the expertise required to manufacture a bistable electrophoretic



display that will show an image even when it is not drawing on battery power. This technology is central to the Kindle because it allows for very long battery life. Ultimately, Amazon contracted with a Taiwanese firm, Prime View International, to make the display. Prime View had considerable expertise in the manufacture of LCDs and was known as an efficient and reliable manufacturer. Estimates suggest that 40 to 50 percent of the value of the display is captured by E Ink, with the rest going to Prime View.

After the display, the next most expensive component is the wireless card that allows the Kindle to connect to Amazon's digital bookstore through a wireless link. The card costs about $40. Novatel Wireless, a South Korean enterprise that has developed considerable expertise in making wireless chipsets for cell phone manufacturers, produces this component. The card includes a $13 chip that was designed by Qualcomm of San Diego. This too is manufactured in Asia. The brain of the Kindle is an $8.64 microprocessor chip designed by Texas-based Freescale Semiconductor. Freescale outsources its chip making to foundries in Taiwan and China. Another key component, the lithium polymer battery, costs about $7.50 and is manufactured in China. In sum, out of a total manufacturing cost of about $185, perhaps $40 to $50 is accounted for by activities undertaken in the United States by E Ink, Qualcomm, and Freescale, with the remainder being outsourced to manufacturers in Taiwan, China, and South Korea.[1]

Introduction

As trade barriers fall and global markets develop, many firms increasingly confront a set of interrelated issues. First, where in the world should production activities be located? Should they be concentrated in a single country, or should they be dispersed around the globe, matching the type of activity with country differences in factor costs, tariff barriers, political risks, and the like to minimize costs and maximize value added? Second, what should be the long-term strategic role of foreign production sites? Should the firm abandon a foreign site if factor costs change, moving production to another more favorable location, or is there value to maintaining an operation at a given location even if underlying economic conditions change? Third, should the firm own foreign production activities, or is it better to outsource those activities to independent vendors? Fourth, how should a globally dispersed supply chain be managed, and what is the role of Internet-based information technology in the management of global logistics? Fifth, should the firm manage global logistics itself, or should it outsource the management to enterprises that specialize in this activity?

The example of the Amazon Kindle discussed in the opening case touches upon some of these issues. Like many modern products, different components of the Kindle are manufactured in different locations to produce a reliable low-cost product. In choosing who should make what components, Amazon was guided by the need to keep the cost of the device low so that it could price aggressively and preempt competitors in the digital reader market. For example, Amazon picked Prime View of Taiwan to make the display screen precisely because that company is among the best in the world at this kind of manufacturing. For Amazon to secure a competitive advantage against intense competition, it had to make the correct choices.

LO1 Strategy, Production, and Logistics

Chapter 13 introduced the concept of the value chain and discussed a number of value creation activities, including production, marketing, logistics, R&D, human resources, and information systems. This chapter will focus on two of these activities—**production** and **logistics**—and attempt to clarify how they might be performed internationally to (1) lower the costs of value creation and (2) add value by better serving customer needs. We will discuss the contributions of information technology to these activities, which has become particularly important in the era of the Internet. Later chapters will look at other value creation activities in this international context (marketing, R&D, and human resource management).

In Chapter 13, we defined *production* as "the activities involved in creating a product." We used the term *production* to denote both service and manufacturing activities, since one can produce a service or produce a physical product. Although in this chapter we focus more on the production of physical goods, one should not forget that the term can also be applied to services. This has become more evident in recent years with the trend among U.S. firms to outsource the "production" of certain service activities to developing nations where labor costs are lower (for example, the trend among many U.S. companies to outsource customer care services to places such as India, where English is widely spoken and labor costs are much lower). Logistics is the activity that controls the transmission of physical materials through the value chain, from procurement through production and into distribution. Production and logistics are closely linked because a firm's ability to perform its production activities efficiently depends on a timely supply of high-quality material inputs, for which logistics is responsible.

The production and logistics functions of an international firm have a number of important strategic objectives.[2] One is to lower costs. Dispersing production activities to various locations around the globe where each activity can be performed most efficiently can lower costs. Costs can also be cut by managing the global supply chain efficiently so

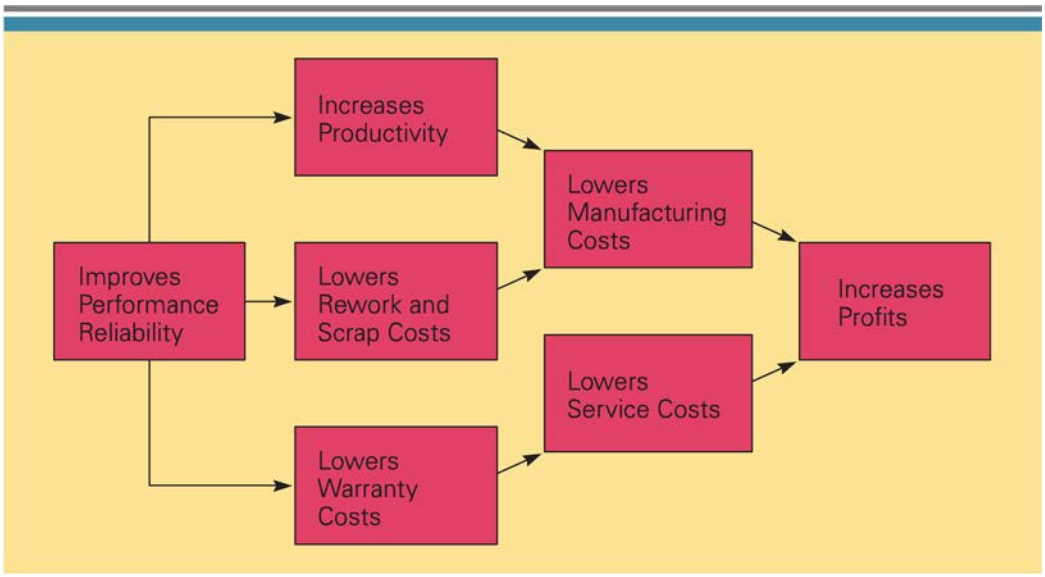


FIGURE 17.1

The Relationship between Quality and Costs

Source: Reprinted from "What Does Product Quality Really Mean?" by David A. Garvin, *Sloan Management Review* 26 (Fall 1984), Figure 1, p. 37, by permission of the publisher. Copyright 1984 by Massachusetts Institute of Technology. All rights reserved.

as to better match supply and demand. Efficient supply chain management reduces the amount of inventory in the system and increases inventory turnover, which means the firm has to invest less working capital in inventory and is less likely to find excess inventory on hand that cannot be sold and has to be written off.

A second strategic objective shared by production and logistics is to increase product quality by eliminating defective products from both the supply chain and the manufacturing process.[3] (In this context, *quality* means *reliability*, implying that the product has no defects and performs well.) The objectives of reducing costs and increasing quality are not independent of each other. As illustrated in Figure 17.1, the firm that improves its quality control will also reduce its costs of value creation. Improved quality control reduces costs by:

- Increasing productivity because time is not wasted producing poor-quality products that cannot be sold, leading to a direct reduction in unit costs.
- Lowering rework and scrap costs associated with defective products.
- Reducing the warranty costs and time associated with fixing defective products.

The effect is to lower the costs of value creation by reducing both production and after-sales service costs.

The principal tool that most managers now use to increase the reliability of their product offering is the Six Sigma quality improvement methodology. The Six Sigma methodology is a direct descendant of the **total quality management** (TQM) philosophy that was widely adopted, first by Japanese companies and then American companies during the 1980s and early 1990s.[4] The TQM philosophy was developed by a number of American consultants such as W. Edwards Deming, Joseph Juran, and A. V. Feigenbaum.[5] Deming identified a number of steps that should be part of any TQM program. He argued that management should embrace the philosophy that mistakes, defects, and poor-quality materials are not acceptable and should be eliminated. He suggested that the quality of supervision should be improved by allowing more time for supervisors to work with employees and by providing them with the tools they need to do the job. Deming recommended that management should create an environment in which employees will



General Electric is one of the major corporations that have embraced Six Sigma. Its commitment to quality is evident in all its industries, from retail to insurance to aviation.

not fear reporting problems or recommending improvements. He believed that work standards should not only be defined as numbers or quotas, but should also include some notion of quality to promote the production of defect-free output. He argued that management has the responsibility to train employees in new skills to keep pace with changes in the workplace. In addition, he believed that achieving better quality requires the commitment of everyone in the company.

Six Sigma, the modern successor to TQM, is a statistically based philosophy that aims to reduce defects, boost productivity, eliminate waste, and cut costs throughout a company. Six Sigma programs have been adopted by several major corporations, such as Motorola, General Electric, and Allied Signal. Sigma comes from the Greek letter that statisticians use to represent a standard deviation from a mean; the higher the number of "sigmas," the smaller the number of errors. At six sigma, a production process would be 99.99966 percent accurate, creating just 3.4 defects per million units. While it is almost impossible for a company to achieve such perfection, Six Sigma quality is a goal that several strive toward. Increasingly, companies are adopting Six Sigma programs to try to boost their product quality and productivity.[6]

The growth of international standards has also focused greater attention on the importance of product quality. In Europe, for example, the European Union requires that the quality of a firm's manufacturing processes and products be certified under a quality standard known as **ISO 9000** before the firm is allowed access to the EU marketplace. Although the ISO 9000 certification process has proved to be somewhat bureaucratic and costly for many firms, it does focus management attention on the need to improve the quality of products and processes.[7]

In addition to the lowering of costs and the improvement of quality, two other objectives have particular importance in international businesses. First, production and logistics functions must be able to accommodate demands for local responsiveness. As we saw in Chapter 12, demands for local responsiveness arise from national differences in consumer tastes and preferences, infrastructure, distribution channels, and host-government demands. Demands for local responsiveness create pressures to decentralize production activities to the major national or regional markets in which the firm does business or to implement flexible manufacturing processes that enable the firm to customize the product coming out of a factory according to the market in which it is to be sold.

Second, production and logistics must be able to respond quickly to shifts in customer demand. In recent years, time-based competition has grown more important.[8] When

consumer demand is prone to large and unpredictable shifts, the firm that can adapt most quickly to these shifts will gain an advantage.[9] As we shall see, both production and logistics play critical roles here.

Where to Produce

LO2

An essential decision facing an international firm is where to locate its production activities to best minimize costs and improve product quality. For the firm contemplating international production, a number of factors must be considered. These factors can be grouped under three broad headings: country factors, technological factors, and product factors.[10]

COUNTRY FACTORS

We reviewed country-specific factors in some detail earlier in the book. Political economy, culture, and relative factor costs differ from country to country. In Chapter 6, we saw that due to differences in factor costs, some countries have a comparative advantage for producing certain products. In Chapters 2, 3, and 4 we saw how differences in political economy and national culture influence the benefits, costs, and risks of doing business in a country. Other things being equal, a firm should locate its various manufacturing activities where the economic, political, and cultural conditions, including relative factor costs, are conducive to the performance of those activities (for an example, see the accompanying Management Focus, which looks at the Philips Electronics NV investment in China). In Chapter 13, we referred to the benefits derived from such a strategy as location economies. We argued that one result of the strategy is the creation of a global web of value creation activities.

Also important in some industries is the presence of global concentrations of activities at certain locations. In Chapter 8, we discussed the role of location externalities in influencing foreign direct investment decisions. Externalities include the presence of an appropriately skilled labor pool and supporting industries.[11] Such externalities can play an important role in deciding where to locate production activities. For example, because of a cluster of semiconductor manufacturing plants in Taiwan, a pool of labor with experience in the semiconductor business has developed. In addition, the plants have attracted a number of supporting industries, such as the manufacturers of semiconductor capital equipment and silicon, which have established facilities in Taiwan to be near their customers. This implies that there are real benefits to locating in Taiwan, as opposed to another location that lacks such externalities. Other things being equal, the externalities make Taiwan an attractive location for semiconductor manufacturing facilities. The same process is now under way in two Indian cities, Hyderabad and Bangalore, where both Western and Indian information technology companies have established operations. For example, locals refer to a section of Hyderabad as "Cyberabad," where Microsoft, IBM, Infosys, and Qualcomm, among others, have major facilities.

Of course, other things are not equal. Differences in relative factor costs, political economy, culture, and location externalities are important, but other factors also loom large. Formal and informal trade barriers obviously influence location decisions (see Chapter 7), as do transportation costs and rules and regulations regarding foreign direct investment (see Chapter 8). For example, although relative factor costs may make a country look attractive as a location for performing a manufacturing activity, regulations prohibiting foreign direct investment may eliminate this option. Similarly, a consideration of factor costs might suggest that a firm should source production of a certain component from a particular country, but trade barriers could make this uneconomical.

Another country factor is expected future movements in its exchange rate (see Chapters 10 and 11). Adverse changes in exchange rates can quickly alter a country's attractiveness as a manufacturing base. Currency appreciation can transform a low-cost



MANAGEMENT FOCUS

Philips in China

The Dutch consumer electronics, lighting, semiconductor, and medical equipment conglomerate Philips Electronics NV has been operating factories in China since 1985, when the country first opened its markets to foreign investors. Then China was seen as the land of unlimited demand, and Philips, like many other Western companies, dreamed of Chinese consumers snapping up its products by the millions. But the company soon found out that one of the big reasons the company liked China—the low wage rates—also meant that few Chinese workers could afford to buy the products they were producing. Chinese wage rates are currently one-third of those in Mexico and Hungary, and 5 percent of those in the United States or Japan. So Philips hit on a new strategy: keep the factories in China but export most of the goods to the United States and elsewhere.

The company now operates 25 wholly owned subsidiaries and joint ventures in China. Together they employ some 30,000 people. Philips exports nearly two-thirds of the $7 billion in products that the factories produce every year. Philips accelerated its Chinese investment in anticipation of China's entry into the World Trade Organization. The company plans to move even more production to China in the future. In 2003, Philips announced it would phase out production of electronic razors in the Netherlands, lay off 2,000 Dutch employees, and move production to China by 2005. A week earlier, Philips had stated it would expand capacity at its semiconductor factories in China, while phasing out production in higher-cost locations elsewhere.

The attractions of China to Philips include continuing low wage rates, an educated workforce, a robust Chinese economy, a stable exchange rate that is pegged to the U.S. dollar, a rapidly expanding industrial base that includes many other Western and Chinese companies that Philips uses as suppliers, and easier access to world markets given China's entry into the WTO. Philips has stated that ultimately its goal is to turn China into a global supply base from which the company's products will be exported around the world. By the mid-2000s more than 25 percent of everything Philips made worldwide came from China, and executives say the figure is rising rapidly. Several products, such as CD and DVD players, are now made only in China. Philips is also starting to give its Chinese factories a greater role in product development. In the TV business, for example, basic development used to occur in Holland but was moved to Singapore in the early 1990s. Now Philips is transferring TV development work to a new R&D center in Suzhou near Shanghai. Similarly, basic product development work on LCD screens for cell phones was recently shifted to Shanghai.

Some observers worry that Philips and companies pursuing a similar strategy might be overdoing it. Too much dependence on China could be dangerous if political, economic, or other problems disrupt production and the company's ability to supply global markets. Some observers believe that it might be better if the manufacturing facilities of companies were more geographically diverse as a hedge against problems in China. The fears of the critics were given some substance in early 2003 when an outbreak of the pneumonia-like SARS (severe acute respiratory syndrome) virus in China resulted in the temporary shutdown of several plants operated by foreign companies and disrupted their global supply chains. Although Philips was not directly affected, it did restrict travel by its managers and engineers to its Chinese plants.[12]

location into a high-cost location. Many Japanese corporations had to grapple with this problem during the 1990s and early 2000s. The relatively low value of the yen on foreign exchange markets between 1950 and 1980 helped strengthen Japan's position as a low-cost location for manufacturing. Between 1980 and the mid-1990s, however, the yen's steady appreciation against the dollar increased the dollar cost of products exported from Japan, making Japan less attractive as a manufacturing location. In response, many Japanese firms moved their manufacturing offshore to lower-cost locations in East Asia.

TECHNOLOGICAL FACTORS

The type of technology a firm uses to perform specific manufacturing activities can be pivotal in location decisions. For example, because of technological constraints, in some

cases it is necessary to perform certain manufacturing activities in only one location and serve the world market from there. In other cases, the technology may make it feasible to perform an activity in multiple locations. Three characteristics of a manufacturing technology are of interest here: the level of fixed costs, the minimum efficient scale, and the flexibility of the technology.

Fixed Costs

As noted in Chapter 13, in some cases the fixed costs of setting up a production plant are so high that a firm must serve the world market from a single location or from a very few locations. For example, it now costs up to $5 billion to set up a state-of-the-art plant to manufacture semiconductor chips. Given this, other things being equal, serving the world market from a single plant sited at a single (optimal) location can make sense.

Conversely, a relatively low level of fixed costs can make it economical to perform a particular activity in several locations at once. This allows the firm to better accommodate demands for local responsiveness. Manufacturing in multiple locations may also help the firm avoid becoming too dependent on one location. Being too dependent on one location is particularly risky in a world of floating exchange rates. Many firms disperse their manufacturing plants to different locations as a "real hedge" against potentially adverse moves in currencies.

Minimum Efficient Scale

The concept of economies of scale tells us that as plant output expands, unit costs decrease. The reasons include the greater utilization of capital equipment and the productivity gains that come with specialization of employees within the plant.[13] However, beyond a certain level of output, few additional scale economies are available. Thus, the "unit cost curve" declines with output until a certain output level is reached, at which point further increases in output realize little reduction in unit costs. The level of output at which most plant-level scale economies are exhausted is referred to as the **minimum efficient scale** of output. This is the scale of output a plant must operate to realize all major plant-level scale economies (see Figure 17.2).

The implications of this concept are as follows: The larger the minimum efficient scale of a plant relative to total global demand, the greater the argument for centralizing production in a single location or a limited number of locations. Alternatively, when the minimum efficient scale of production is low relative to global demand, it may be economical to manufacture a product at several locations. For example, the minimum efficient scale for a plant to manufacture personal computers is about 250,000 units a year, while the total global demand exceeds 35 million units a year. The low level of

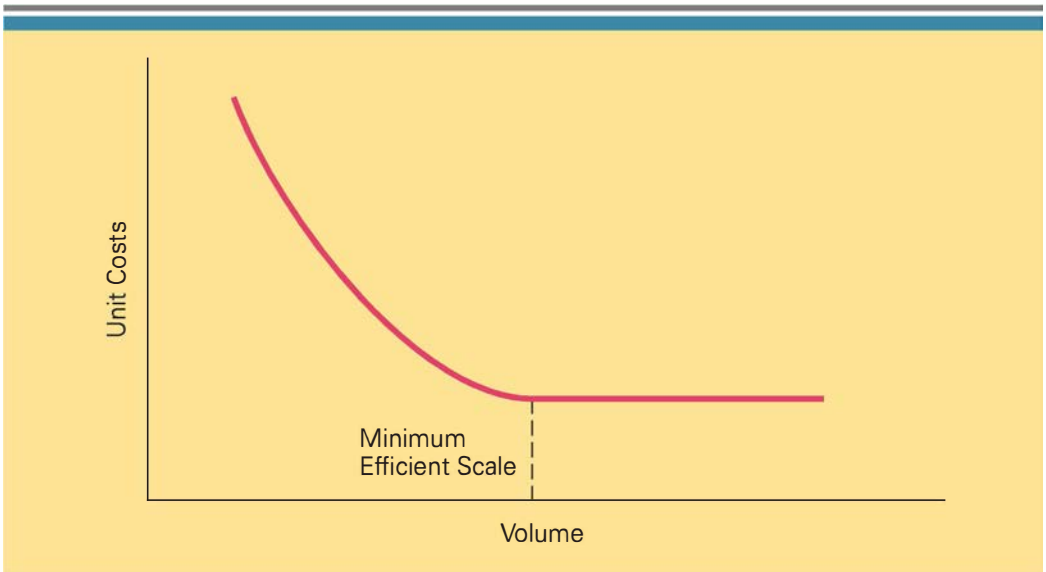


FIGURE 17.2
A Typical Unit Cost Curve

minimum efficient scale in relation to total global demand makes it economically feasible for a company such as Dell to assemble PCs in six locations.

As in the case of low fixed costs, the advantages of a low minimum efficient scale include allowing the firm to accommodate demands for local responsiveness or to hedge against currency risk by manufacturing the same product in several locations.

Flexible Manufacturing and Mass Customization

Central to the concept of economies of scale is the idea that the best way to achieve high efficiency, and hence low unit costs, is through the mass production of a standardized output. The trade-off implicit in this idea is between unit costs and product variety. Producing greater product variety from a factory implies shorter production runs, which in turn implies an inability to realize economies of scale. That is, wide product variety makes it difficult for a company to increase its production efficiency and thus reduce its unit costs. According to this logic, the way to increase efficiency and drive down unit costs is to limit product variety and produce a standardized product in large volumes.

This view of production efficiency has been challenged by the rise of flexible manufacturing technologies. The term **flexible manufacturing technology**—or **lean production**, as it is often called—covers a range of manufacturing technologies designed to (1) reduce setup times for complex equipment, (2) increase the utilization of individual machines through better scheduling, and (3) improve quality control at all stages of the manufacturing process.[14] Flexible manufacturing technologies allow the company to produce a wider variety of end products at a unit cost that at one time could be achieved only through the mass production of a standardized output. Research suggests the adoption of flexible manufacturing technologies may actually increase efficiency and lower unit costs relative to what can be achieved by the mass production of a standardized output, while at the same time enabling the company to customize its product offering to a much greater extent than was once thought possible. The term **mass customization** has been coined to describe the ability of companies to use flexible manufacturing technology to reconcile two goals that were once thought to be incompatible—low cost and product customization.[15] Flexible manufacturing technologies vary in their sophistication and complexity.

One of the most famous examples of a flexible manufacturing technology, Toyota's production system, has been credited with making Toyota the most efficient auto company in the world. (Despite Toyota's recent problems with sudden uncontrolled acceleration, the company continues to be an efficient producer of high-quality automobiles, according to JD Power, which produces an annual quality survey. Toyota's Lexus models continue to top JD Power's quality rankings.)[16] Toyota's flexible manufacturing system was developed by one of the company's engineers, Taiichi Ohno. After working at Toyota for five years and visiting Ford's U.S. plants, Ohno became convinced that the mass production philosophy for making cars was flawed. He saw numerous problems with mass production.

First, long production runs created massive inventories that had to be stored in large warehouses. This was expensive, both because of the cost of warehousing and because inventories tied up capital in unproductive uses. Second, if the initial machine settings were wrong, long production runs resulted in the production of a large number of defects (i.e., waste). Third, the mass production system was unable to accommodate consumer preferences for product diversity.

In response, Ohno looked for ways to make shorter production runs economical. He developed a number of techniques designed to reduce setup times for production equipment (a major source of fixed costs). By using a system of levers and pulleys, he reduced the time required to change dies on stamping equipment from a full day in 1950 to three minutes by 1971. This made small production runs economical, which allowed Toyota to respond better to consumer demands for product diversity. Small production runs also eliminated the need to hold large inventories, thereby reducing warehousing costs. Plus, small product runs and the lack of inventory meant that defective parts were produced

only in small numbers and entered the assembly process immediately. This reduced waste and helped trace defects back to their source to fix the problem. In sum, these innovations enabled Toyota to produce a more diverse product range at a lower unit cost than was possible with conventional mass production.[17]

Flexible machine cells are another common flexible manufacturing technology. A flexible machine cell is a grouping of various types of machinery, a common materials handler, and a centralized cell controller (computer). Each cell normally contains four to six machines capable of performing a variety of operations. The typical cell is dedicated to the production of a family of parts or products. The settings on machines are computer controlled, which allows each cell to switch quickly between the production of different parts or products.

Improved capacity utilization and reductions in work in progress (that is, stockpiles of partly finished products) and in waste are major efficiency benefits of flexible machine cells. Improved capacity utilization arises from the reduction in setup times and from the computer-controlled coordination of production flow between machines, which eliminates bottlenecks. The tight coordination between machines also reduces work-in-progress inventory. Reductions in waste are due to the ability of computer-controlled machinery to identify ways to transform inputs into outputs while producing a minimum of unusable waste material. While freestanding machines might be in use 50 percent of the time, the same machines when grouped into a cell can be used more than 80 percent of the time and produce the same end product with half the waste. This increases efficiency and results in lower costs.

The effects of installing flexible manufacturing technology on a company's cost structure can be dramatic. The Ford Motor Company has been introducing flexible manufacturing technologies into its automotive plants around the world. These new technologies should allow Ford to produce multiple models from the same line, and to switch production from one model to another much more quickly than in the past, allowing Ford to take $2 billion out of its cost structure.[18]

Besides improving efficiency and lowering costs, flexible manufacturing technologies enable companies to customize products to the demands of small consumer groups—at a cost that at one time could be achieved only by mass-producing a standardized output. Thus, the technologies help a company achieve mass customization, which increases its customer responsiveness. Most important for international business, flexible manufacturing



In 2009, Ford Motor Company renovated its Louisville truck plant allowing for flexible manufacturing. What other industries could benefit from flexible manufacturing?

technologies can help a firm customize products for different national markets. The importance of this advantage cannot be overstated. When flexible manufacturing technologies are available, a firm can manufacture products customized to various national markets at a single factory sited at the optimal location. And it can do this without absorbing a significant cost penalty. Thus, firms no longer need to establish manufacturing facilities in each major national market to provide products that satisfy specific consumer tastes and preferences, part of the rationale for a localization strategy (Chapter 13).

Summary

A number of technological factors support the economic arguments for concentrating production facilities in a few choice locations or even in a single location. Other things being equal, when fixed costs are substantial, the minimum efficient scale of production is high, and/or flexible manufacturing technologies are available, the arguments for concentrating production at a few choice locations are strong. This is true even when substantial differences in consumer tastes and preferences exist between national markets because flexible manufacturing technologies allow the firm to customize products to national differences at a single facility. Alternatively, when fixed costs are low, the minimum efficient scale of production is low, and flexible manufacturing technologies are not available, the arguments for concentrating production at one or a few locations are not as compelling. In such cases, it may make more sense to manufacture in each major market in which the firm is active if this helps the firm better respond to local demands. This holds only if the increased local responsiveness more than offsets the cost disadvantages of not concentrating manufacturing. With the advent of flexible manufacturing technologies and mass customization, such a strategy is becoming less attractive. In sum, technological factors are making it feasible, and necessary, for firms to concentrate manufacturing facilities at optimal locations. Trade barriers and transportation costs are major brakes on this trend.

PRODUCT FACTORS

Two product features affect location decisions. The first is the product's *value-to-weight* ratio because of its influence on transportation costs. Many electronic components and pharmaceuticals have high value-to-weight ratios; they are expensive and they do not weigh very much. Thus, even if they are shipped halfway around the world, their transportation costs account for a very small percentage of total costs. Given this, other things being equal, there is great pressure to produce these products in the optimal location and to serve the world market from there. The opposite holds for products with low value-to-weight ratios. Refined sugar, certain bulk chemicals, paint, and petroleum products all have low value-to-weight ratios; they are relatively inexpensive products that weigh a lot. Accordingly, when they are shipped long distances, transportation costs account for a large percentage of total costs. Thus, other things being equal, there is great pressure to make these products in multiple locations close to major markets to reduce transportation costs.

The other product feature that can influence location decisions is whether the product serves universal needs, needs that are the same all over the world. Examples include many industrial products (e.g., industrial electronics, steel, bulk chemicals) and modern consumer products (e.g., handheld calculators, personal computers, video game consoles). Because there are few national differences in consumer taste and preference for such products, the need for local responsiveness is reduced. This increases the attractiveness of concentrating production at an optimal location.

LOCATING PRODUCTION FACILITIES

There are two basic strategies for locating production facilities: concentrating them in a centralized location and serving the world market from there, or decentralizing them in various regional or national locations that are close to major markets. The appropriate

TABLE 17.1

Location Strategy and Production

	Concentrated Production Favored	Decentralized Production Favored
Country Factors		
Differences in political economy	Substantial	Few
Differences in culture	Substantial	Few
Differences in factor costs	Substantial	Few
Trade barriers	Few	Substantial
Location externalities	Important in industry	Not important in industry
Exchange rates	Stable	Volatile
Technological Factors		
Fixed costs	High	Low
Minimum efficient scale	High	Low
Flexible manufacturing technology	Available	Not available
Product Factors		
Value-to-weight ratio	High	Low
Serves universal needs	Yes	No

strategic choice is determined by the various country-specific, technological, and product factors discussed in this section and summarized in Table 17.1.

As can be seen, concentration of production makes most sense when:

- Differences between countries in factor costs, political economy, and culture have a substantial impact on the costs of manufacturing in various countries.
- Trade barriers are low.
- Externalities arising from the concentration of like enterprises favor certain locations.
- Important exchange rates are expected to remain relatively stable.
- The production technology has high fixed costs and high minimum efficient scale relative to global demand, or flexible manufacturing technology exists.
- The product's value-to-weight ratio is high.
- The product serves universal needs.

Alternatively, decentralization of production is appropriate when:

- Differences between countries in factor costs, political economy, and culture do not have a substantial impact on the costs of manufacturing in various countries.
- Trade barriers are high.
- Location externalities are not important.
- Volatility in important exchange rates is expected.
- The production technology has low fixed costs and low minimum efficient scale, and flexible manufacturing technology is not available.
- The product's value-to-weight ratio is low.
- The product does not serve universal needs (that is, significant differences in consumer tastes and preferences exist between nations).

In practice, location decisions are seldom clear-cut. For example, it is not unusual for differences in factor costs, technological factors, and product factors to point toward concentrated production while a combination of trade barriers and volatile exchange

rates points toward decentralized production. This seems to be the case in the world automobile industry. Although the availability of flexible manufacturing and cars' relatively high value-to-weight ratios suggest concentrated manufacturing, the combination of formal and informal trade barriers and the uncertainties of the world's current floating exchange rate regime (see Chapter 10) have inhibited firms' ability to pursue this strategy. For these reasons, several automobile companies have established "top-to-bottom" manufacturing operations in three major regional markets: Asia, North America, and Western Europe.

THE HIDDEN COSTS OF FOREIGN LOCATIONS

There may be some "hidden costs" to basing production in a foreign location. Numerous anecdotes suggest that high employee turnover, shoddy workmanship, poor product quality, and low productivity are significant issues in some outsourcing locations. Microsoft, for example, established a major facility in Hyderabad, India, for four very good reasons. First, the wage rate of software programmers in India is one-third of that in the United States. Second, India has an excellent higher education system that graduates a lot of computer science majors every year. Third, there was already a high concentration of information technology companies and workers in Hyderabad. Fourth, many of Microsoft's highly skilled Indian employees, after spending years in the United States, wanted to return home, and Microsoft saw the Hyderabad facility as a way of holding on to this valuable human capital.

However, the company has found that the turnover rate among its Indian employees is higher than in the United States. Demand for software programmers in India is high and many employees are prone to switch jobs to get better pay. Although Microsoft has tried to limit turnover by offering good benefits and long-term incentive pay, such as stock grants to high performers who stay with the company, many of the Indians who were hired locally apparently place little value on long-term incentives and prefer higher current pay. High employee turnover, of course, has a negative impact on productivity. One Microsoft manager in India noted that 40 percent of his core team had left within the past 12 months, making it very difficult to stay on track with development projects.[19]

Microsoft is not alone in experiencing this problem. The manager of an electronics company that outsourced the manufacture of wireless headsets to China noted that after four years of frustrations with late deliveries and poor quality, his company decided to move production *back* to the United States. In his words: "On the face of it, labor costs seemed so much lower in China that the decision to move production there was a very easy one. In retrospect, I wish we had looked much closer at productivity and workmanship. We have actually lost market share because of this decision."[20] The lesson here is that it is important to look beyond pay rates and make judgments about employee productivity before deciding whether to outsource activities to foreign locations.

LO3 The Strategic Role of a Foreign Production Site

Whatever the rationale behind establishing a foreign production facility, the strategic role of foreign sites can evolve over time.[21] Initially, many foreign sites are established where labor costs are low. Their strategic role typically is to produce labor-intensive products at as low a cost as possible. For example, beginning in the 1970s, many U.S. firms in the computer and telecommunication equipment businesses established factories across Southeast Asia to manufacture electronic components, such as circuit boards and semiconductors, at the lowest possible cost. They located their factories in countries such as Malaysia, Thailand, and Singapore precisely because each of these countries offered an attractive combination of low labor costs, adequate infrastructure, and a favorable

tax and trade regime. Initially, the components produced by these factories were designed elsewhere and the final product was assembled elsewhere. Over time, however, the strategic role of some of these factories has expanded; they have become important centers for the design and final assembly of products for the global marketplace. For example, Hewlett-Packard's operation in Singapore was established as a low-cost location for the production of circuit boards, but the facility has become the center for the design and final assembly of portable ink-jet printers for the global marketplace (see the accompanying Management Focus). A similar process seems to be occurring at some of the factories that Philips has established in China (see the Management Focus on Philips).

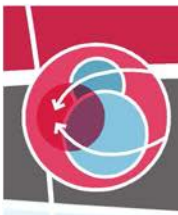
Such upward migration in the strategic role of foreign production sites arises because many foreign sites upgrade their own capabilities.[22] This improvement comes from two sources. First, pressure from the center to improve a site's cost structure and/or customize a product to the demands of consumers in a particular nation can start a chain of events that ultimately leads to development of additional capabilities at that factory. For example, to meet centrally mandated directions to drive down costs, engineers at HP's Singapore factory argued that they needed to redesign products so they could be manufactured at a lower cost. This led to the establishment of a design center in Singapore. As this design center proved its worth, HP executives realized the importance of co-locating design and manufacturing operations. They increasingly transferred more design responsibilities to the Singapore factory. In addition, the Singapore factory ultimately became the center for the design of products tailored to the needs of the Asian market. This made good strategic sense because it meant products were being designed by engineers who were close to the Asian market and probably had a good understanding of the needs of that market, as opposed to engineers located in the United States.

A second source of improvement in the capabilities of a foreign site can be the increasing abundance of advanced factors of production in the nation in which the factory is located. Many nations that were considered economic backwaters a generation ago have been experiencing rapid economic development during the past 20 years. Their communication and transportation infrastructures and the education level of the population have improved. While these countries once lacked the advanced infrastructure required to support sophisticated design, development, and manufacturing operations, this is often no longer the case. This has made it much easier for factories based in these nations to take on a greater strategic role.

Because of such developments, many international businesses are moving away from a system in which their foreign facilities were viewed as nothing more than low-cost production facilities and toward one where they are viewed as globally dispersed centers of excellence.[23] In this new model, foreign sites may take the lead role for the design and manufacture of products to serve important national or regional markets or even the global market. The development of such dispersed centers of excellence is consistent with the concept of a transnational strategy, introduced in Chapter 13. A major aspect of a transnational strategy is a belief in **global learning**—the idea that valuable knowledge does not reside just in a firm's domestic operations; it may also be found in its foreign subsidiaries. Foreign factories that upgrade their capabilities over time are creating valuable knowledge that might benefit the whole corporation.

Managers of international businesses need to remember that foreign factories can improve their capabilities over time, and this can be of immense strategic benefit to the firm. Rather than viewing foreign factories simply as sweatshops where unskilled labor churns out low-cost goods, managers need to see them as potential centers of excellence and to encourage and foster attempts by local managers to upgrade the capabilities of their factories and, thereby, enhance their strategic standing within the corporation.

Such a process does imply that once a foreign factory has been established and valuable skills have been accumulated, it may not be wise to switch production to another



MANAGEMENT FOCUS

Hewlett-Packard in Singapore

In the late 1960s, Hewlett-Packard was looking around Asia for a low-cost location to produce electronic components that were to be manufactured using labor-intensive processes. The company looked at several Asian locations and eventually settled on Singapore, opening its first factory there in 1970. Although Singapore did not have the lowest labor costs in the region, costs were low relative to North America. Plus, the Singapore location had several important benefits that could not be found at many other locations in Asia. The education level of the local workforce was high. English was widely spoken. The government of Singapore seemed stable and committed to economic development, and the city-state had one of the better infrastructures in the region, including good communication and transportation networks and a rapidly developing industrial and commercial base. HP also extracted favorable terms from the Singapore government with regard to taxes, tariffs, and subsidies.

At its start, the plant manufactured only basic components. The combination of low labor costs and a favorable tax regime helped to make this plant profitable early. In 1973, HP transferred the manufacture of one of its basic handheld calculators from the United States to Singapore. The objective was to reduce manufacturing costs, which the Singapore factory was quickly able to do. Increasingly confident in the capability of the Singapore factory to handle entire products, as opposed to just components, HP's management transferred other products to Singapore over the next few years including keyboards, solid-state displays, and integrated circuits. However, all these products were still designed, developed, and initially produced in the United States.

The plant's status shifted in the early 1980s when HP embarked on a worldwide campaign to boost product quality and reduce costs. HP transferred the production of its HP41C handheld calculator to Singapore. The managers at the Singapore plant were given the goal of substantially reducing manufacturing costs. They argued that this could be achieved only if they were allowed to redesign the product so it could be manufactured at a lower overall cost. HP's central management agreed, and 20 engineers from the Singapore facility were transferred to the United States for one year to learn how to design application-specific integrated circuits. They then brought this expertise back to Singapore and set about redesigning the HP41C.

The results were a huge success. By redesigning the product, the Singapore engineers reduced manufacturing costs for the HP41C by 50 percent. Using this newly acquired capability for product design, the Singapore facility then set about redesigning other products it produced. HP's corporate managers were so impressed with the progress made at the factory that they transferred production of the entire calculator line to Singapore in 1983. This was followed by the partial transfer of ink-jet production to Singapore in 1984 and keyboard production in 1986. In all cases, the facility redesigned the products and often reduced unit manufacturing costs by more than 30 percent. The initial development and design of all these products, however, still occurred in the United States.

In the late 1980s and 1990s, the Singapore plant assumed added responsibilities, particularly in the ink-jet printer business. The factory was given the job of redesigning an HP ink-jet printer for the Japanese market. Although the initial product redesign was a market failure, the managers at Singapore pushed to be allowed to try again. They were given the job of redesigning HP's DeskJet 505 printer for the Japanese market. This time the redesigned product was a success, garnering significant sales in Japan. Emboldened by this success, the plant has continued to take on additional design responsibilities. Today, it is viewed as a "lead plant" within HP's global network, with primary responsibility not just for manufacturing, but also for the development and design of a family of small ink-jet printers targeted at the Asian market.[24]

location simply because some underlying variable, such as wage rates, has changed.[25] HP has kept its facility in Singapore, rather than switching production to a location where wage rates are now much lower, such as Vietnam, because it recognizes that the Singapore factory has accumulated valuable skills that more than make up for the higher wage rates. Thus, when reviewing the location of production facilities, the international

manager must consider the valuable skills that may have been accumulated at various locations, and the impact of those skills on factors such as productivity and product design.

Outsourcing Production: Make-or-Buy Decisions

LO4

International businesses frequently face **make-or-buy decisions**, decisions about whether they should perform a certain value creation activity themselves or outsource it to another entity.[26] Historically, most outsourcing decisions have involved the manufacture of physical products. Most manufacturing firms have done their own final assembly, but have had to decide whether to vertically integrate and manufacture their own component parts or outsource the production of such parts, purchasing them from independent suppliers. Such make-or-buy decisions are an important aspect of the strategy of many firms. In the automobile industry, for example, the typical car contains more than 10,000 components, so automobile firms constantly face make-or-buy decisions. Toyota produces less than 30 percent of the value of cars that roll off its assembly lines. The remaining 70 percent, mainly accounted for by component parts and complex subassemblies, comes from independent suppliers. In the athletic shoe industry, the make-or-buy issue has been taken to an extreme with companies such as Nike and Reebok having no involvement in manufacturing; all production has been outsourced, primarily to manufacturers based in low-wage countries.

In recent years, the outsourcing decision has gone beyond the manufacture of physical products to embrace the production of service activities. For example, many U.S.-based companies, from credit card issuers to computer companies, have outsourced their customer call centers to India. They are "buying" the customer call center function, while "making" other parts of the product in-house. Similarly, many information technology companies have been outsourcing some parts of the software development process, such as testing computer code written in the United States, to independent providers based in India. Such companies are "making" (writing) most of the code in-house, but "buying," or outsourcing, part of the production process—testing—to independent companies. India is often the focus of such outsourcing because English is widely spoken there; the nation has a well-educated workforce, particularly in engineering fields; and the pay is much lower than in the United States (a call center worker in India earns about $200 to $300 a month, about one-tenth of the comparable U.S. wage).[27]

Outsourcing decisions pose plenty of problems for purely domestic businesses but even more problems for international businesses. These decisions in the international arena are complicated by the volatility of countries' political economies, exchange rate movements, changes in relative factor costs, and the like. In this section, we examine the arguments for making products in-house and for buying them, and we consider the trade-offs involved in such a decision. Then we discuss strategic alliances as an alternative to producing all or part of a product within the company.



Nike relies on outsourcing to manufacture its products; however, the company has received worldwide criticism for turning its back on social responsibility for the sake of profit.

THE ADVANTAGES OF MAKE

The arguments that support making all or part of a product in-house—vertical integration—are fivefold. In-house production may be associated with lower costs, facilitate investments in highly specialized assets, protect proprietary product technology, enable the firm to accumulate valuable skills and capabilities, and ease the scheduling of adjacent processes.

Lowering Costs

It may pay a firm to continue manufacturing a product or component part in-house if the firm is more efficient at that production activity than any other enterprise.

Facilitating Specialized Investments

Sometimes firms have to invest in specialized assets in order to do business with another enterprise.[28] A **specialized asset** is an asset whose value is contingent upon a particular relationship persisting. For example, imagine Ford of Europe has developed a new, high-performance, high-quality, and uniquely designed fuel injection system. The increased fuel efficiency will help sell Ford cars. Ford must decide whether to make the system in-house or to contract out the manufacturing to an independent supplier. Manufacturing these uniquely designed systems requires investments in equipment that can be used only for this purpose; it cannot be used to make fuel injection systems for any other automaker. Thus, investment in this equipment constitutes an investment in specialized assets. When, as in this situation, one firm must invest in specialized assets to supply another, mutual dependency is created. In such circumstances, each party might fear the other will abuse the relationship by seeking more favorable terms.

To appreciate this, let us first examine this situation from the perspective of an independent supplier who has been asked by Ford to make this investment. The supplier might reason that once it has made the investment, it will become dependent on Ford for business since Ford is the only possible customer for the output of this equipment. The supplier perceives this as putting Ford in a strong bargaining position and worries that once the specialized investment has been made, Ford might use this to squeeze down prices for the systems. Given this risk, the supplier declines to make the investment in specialized equipment.

Now take the position of Ford. Ford might reason that if it contracts out production of these systems to an independent supplier, it might become too dependent on that supplier for a vital input. Because specialized equipment is required to produce the fuel injection systems, Ford cannot easily switch its orders to other suppliers who lack that equipment. (It would face high switching costs.) Ford perceives this as increasing the bargaining power of the supplier and worries that the supplier might use its bargaining strength to demand higher prices.

Thus, the mutual dependency that outsourcing would create makes Ford nervous and scares away potential suppliers. The problem here is lack of trust. Neither party completely trusts the other to play fair. Consequently, Ford might reason that the only safe way to get the new fuel injection systems is to manufacture them itself. It may be unable to persuade any independent supplier to manufacture them. Thus, Ford decides to make rather than buy.

In general, we can predict that when substantial investments in specialized assets are required to manufacture a component, the firm will prefer to make the component internally rather than contract it out to a supplier. Substantial empirical evidence supports this prediction.[29]

Protecting Proprietary Product Technology

Proprietary product technology is unique to a firm. If it enables the firm to produce a product containing superior features, proprietary technology can give the firm a competitive advantage. The firm would not want competitors to get this technology. If the firm outsources the production of entire products or components containing proprietary technology, it runs the risk that those suppliers will expropriate the technology for their own use or that they will sell it to the firm's competitors. Thus, to maintain control over its technology, the firm might prefer to make such products or component parts in-house.

Accumulating Dynamic Capabilities

Competitive advantage is not a static concept. The capability to effectively and efficiently produce goods and services is one that evolves over time. Firms can learn

through their experience how to lower cost, design better products, increase product reliability, and so on. Their capabilities (skills), in other words, are *dynamic*; they are learned through experience (the term **dynamic capabilities** is used to describe skills that become more valuable over time through learning).[30] Also, the experience learned producing one kind of product might create a capability that is then useful for producing another kind of product.

For example, in the late 1990s under the leadership of CEO Steven Jobs, Apple developed some very valuable design capabilities. Under Job's direction, Apple hired talented industrial designers and gave them a *major* say in product development. Originally these designers worked on Apple's line of desktop and laptop computers. They produced computers that were differentiated by superior design elegance from those produced by its rivals. Through this process, over time the design team built up considerable capabilities in industrial design as applied to computing devices for consumers. Subsequently, Apple has been able to leverage these capabilities to produce a range of elegantly designed products that have been very successful, including the iPod, iPhone, and iPad.

Now imagine if in an effort to save costs, instead of hiring its own designers, Apple had outsourced design to an independent design firm (such firms do exit). If it had done so, Apple may never have acquired the capabilities that subsequently enabled it to design elegant products like the iPhone and iPad. Instead, those capabilities would have resided in the design firm. Put differently, Apple would have missed out on the opportunity to establish a competitive advantage based on a capability in industrial design.



The Apple example points to one of the problems with outsourcing. Firms that outsource activities to gain a short-term cost advantage may miss out on the opportunity to subsequently build important capabilities in that activity. Critics claim that the rush by American firms to outsource activities during the 1990s and 2000s to low-cost foreign suppliers has had just this effect.[31] Although each decision may have seemed reasonable in isolation when it was taken, the cumulative effect of outsourcing may be to pass up on the opportunity to develop capabilities in that activity, capabilities that might subsequently lead to a competitive advantage. When Amazon was deciding who should make the display screen for the Kindle, for example, it had to go to a Taiwanese firm. All American enterprises had exited the LCD industry in the 1990s and none now had the capability to make what Amazon required (see the opening case).

The key point here is that firms should be very careful about what they outsource. They should not outsource activities for a short-term cost advantage if those activities are potentially important for the long-term competitive advantage of the enterprise. Some would argue that Boeing made this mistake when it outsourced the production of wings for its 787 jet aircraft. Although the decision may have seemed reasonable when judged from a pure cost perspective, Boeing is no longer accumulating capabilities in the design of a key component in large commercial jet aircraft, and this may hurt the company down the road.

Improving Scheduling

Another argument for producing all or part of a product in-house is that production cost savings result because it makes planning, coordination, and scheduling of adjacent processes easier.[32] This is particularly important in firms with just-in-time inventory systems (discussed later in the chapter). In the 1920s, for example, Ford profited from tight coordination and scheduling made possible by backward vertical integration into steel foundries, iron ore shipping, and mining. Deliveries at Ford's foundries on the Great Lakes were coordinated so well that ore was turned into engine blocks within 24 hours. This substantially reduced Ford's production costs by eliminating the need to hold excessive ore inventories.

For international businesses that source worldwide, scheduling problems can be exacerbated by the time and distance between the firm and its suppliers. This is true whether the firms use their own subunits as suppliers or use independent suppliers. However, ownership of upstream production facilities is not the issue here. By using information technology, firms can attain tight coordination between different stages in the production process.

THE ADVANTAGES OF BUY

Buying component parts, or an entire product, from independent suppliers can give the firm greater flexibility, can help drive down the firm's cost structure, and may help the firm capture orders from international customers.

Strategic Flexibility

The great advantage of buying component parts, or even an entire product, from independent suppliers is that the firm can maintain its flexibility, switching orders between suppliers as circumstances dictate. This is particularly important internationally, where changes in exchange rates and trade barriers can alter the attractiveness of supply sources. One year Hong Kong might offer the lowest cost for a particular component, and the next year Mexico may. Many firms source the same products from suppliers based in two countries primarily as a hedge against adverse movements in factor costs, exchange rates, and the like.

Sourcing products from independent suppliers can also be advantageous when the optimal location for manufacturing a product is beset by political risks. Under such circumstances, foreign direct investment to establish a component manufacturing operation in that country would expose the firm to political risks. The firm can avoid many of these risks by buying from an independent supplier in that country, thereby maintaining the flexibility to switch sourcing to another country if a war, revolution, or other political change alters that country's attractiveness as a supply source.

However, maintaining strategic flexibility has its downside. If a supplier perceives the firm will change suppliers in response to changes in exchange rates, trade barriers, or general political circumstances, that supplier might not be willing to make investments in specialized plants and equipment that would ultimately benefit the firm.

Lower Costs

Although making a product or component part in-house—vertical integration—is often undertaken to lower costs, it may have the opposite effect. When this is the case, outsourcing may lower the firm's cost structure. Making all or part of a product in-house increases an organization's scope, and the resulting increase in organizational complexity can raise a firm's cost structure. There are three reasons for this.

First, the greater the number of subunits in an organization, the more problems coordinating and controlling those units. Coordinating and controlling subunits require top management to process large amounts of information about subunit activities. The greater the number of subunits, the more information top management must process and the harder it is to do well. Theoretically, when the firm becomes involved in too many activities, headquarters management will be unable to effectively control all of them, and the resulting inefficiencies will more than offset any advantages derived from vertical integration.[33] This can be particularly serious in an international business, where the problem of controlling subunits is exacerbated by distance and differences in time, language, and culture.

Second, the firm that vertically integrates into component part manufacture may find that because its internal suppliers have a captive customer in the firm, they lack an incentive to reduce costs. The fact that they do not have to compete for orders with other suppliers may result in high operating costs. The managers of the supply operation may be tempted to pass on cost increases to other parts of the firm in the form of higher transfer prices, rather than looking for ways to reduce those costs.

Third, vertically integrated firms have to determine appropriate prices for goods transferred to subunits within the firm. This is a challenge in any firm, but it is even more complex in international businesses. Different tax regimes, exchange rate movements, and headquarters' ignorance about local conditions all increase the complexity of transfer pricing decisions. This complexity enhances internal suppliers' ability to manipulate transfer prices to their advantage, passing cost increases downstream rather than looking for ways to reduce costs.

The firm that buys its components from independent suppliers can avoid all these problems and the associated costs. The firm that sources from independent suppliers has fewer subunits to control. The incentive problems that occur with internal suppliers do not arise when independent suppliers are used. Independent suppliers know they must continue to be efficient if they are to win business from the firm. Also, because independent suppliers' prices are set by market forces, the transfer pricing problem does not exist. In sum, the bureaucratic inefficiencies and resulting costs that can arise when firms vertically integrate backward and produce their own components are avoided by buying component parts from independent suppliers.

Offsets

Another reason for outsourcing some manufacturing to independent suppliers based in other countries is that it may help the firm capture more orders from that country. Offsets are common in the commercial aerospace industry. For example, before Air India places a large order with Boeing, the Indian government might ask Boeing to push some subcontracting work toward Indian manufacturers. This is not unusual in international business. Representatives of the U.S. government have repeatedly urged Japanese automobile companies to purchase more component parts from U.S. suppliers to partially offset the large volume of automobile exports from Japan to the United States.

TRADE-OFFS

Clearly, make-or-buy decisions involve trade-offs. The benefits of making all or part of a product in-house seem to be greatest when highly specialized assets are involved, when in-house production is necessary for protecting proprietary technology, when the firm may build valuable capabilities over time if it continues to perform an activity in-house, or when the firm is simply more efficient than external suppliers at performing a particular activity. When these conditions are not present, the risk of strategic inflexibility and organizational problems suggest it may be better to contract out some or all production to independent suppliers. Because issues of strategic flexibility and organizational control loom even larger for international businesses than purely domestic ones, an international business should be particularly wary of vertical integration into component part manufacture. In addition, some outsourcing in the form of offsets may help a firm gain larger orders in the future.

STRATEGIC ALLIANCES WITH SUPPLIERS

Several international businesses have tried to reap some benefits of vertical integration without the associated organizational problems by entering strategic alliances with essential suppliers. For example, there was an alliance between Kodak and Canon, under which Canon built photocopiers for sale by Kodak; an alliance between Microsoft and Flextronics, under which Flextronics built the Xbox for Microsoft; and an alliance between Boeing and several Japanese companies to build its jet aircraft, including the 787. By these alliances, Kodak, Microsoft, and Boeing have committed themselves to long-term relationships with these suppliers, which have encouraged the suppliers to undertake specialized investments. Strategic alliances build trust between the firm and its suppliers. Trust is built when a firm makes a credible commitment to continue purchasing from a supplier on reasonable terms. For example, the firm may invest money in a

supplier—perhaps by taking a minority shareholding—to signal its intention to build a productive, mutually beneficial long-term relationship.

This kind of arrangement between the firm and its parts suppliers was pioneered in Japan by large auto companies such as Toyota. Many Japanese automakers have cooperative relationships with their suppliers that go back decades. In these relationships, the auto companies and their suppliers collaborate on ways to increase value added by, for example, implementing just-in-time inventory systems or cooperating in the design of component parts to improve quality and reduce assembly costs. These relationships have been formalized when the auto firms acquired minority shareholdings in many of their essential suppliers to symbolize their desire for long-term cooperative relationships with them. At the same time, the relationship between the firm and each essential supplier remains market mediated and terminable if the supplier fails to perform. By pursuing such a strategy, the Japanese automakers capture many of the benefits of vertical integration, particularly those arising from investments in specialized assets, without suffering the organizational problems that come with formal vertical integration. The parts suppliers also benefit from these relationships because they grow with the firm they supply and share in its success.[34]

The adoption of just-in-time inventory systems (JIT), computer-aided design (CAD), and computer-aided manufacturing (CAM) over the past two decades seems to have increased pressures for firms to establish long-term relationships with their suppliers. JIT, CAD, and CAM systems all rely on close links between firms and their suppliers supported by substantial specialized investment in equipment and information systems hardware. To get a supplier to agree to adopt such systems, a firm must make a credible commitment to an enduring relationship with the supplier—it must build trust with the supplier. It can do this within the framework of a strategic alliance.

Alliances are not all good. Like formal vertical integration, a firm that enters long-term alliances may limit its strategic flexibility by the commitments it makes to its alliance partners. As we saw in Chapter 15 when we considered alliances between competitors, a firm that allies itself with another firm risks giving away key technological know-how to a potential competitor.

LO5 Managing a Global Supply Chain

Logistics encompasses the activities necessary to get materials from suppliers to a manufacturing facility, through the manufacturing process, and out through a distribution system to the end user.[35] In the international business, the logistics function manages the global supply chain. The twin objectives of logistics are to manage a firm's global supply chain at the lowest possible cost and in a way that best serves customer needs, thereby lowering the costs of value creation and helping the firm establish a competitive advantage through superior customer service.

The potential for reducing costs through more efficient logistics is enormous. For the typical manufacturing enterprise, material costs account for between 50 and 70 percent of revenues, depending on the industry. Even a small reduction in these costs can have a substantial impact on profitability. According to one estimate, for a firm with revenues of $1 million, a return on investment rate of 5 percent, and materials costs that are 50 percent of sales revenues, a $15,000 increase in total profits could be achieved either by increasing sales revenues 30 percent or by reducing materials costs by 3 percent.[36] In a saturated market, it would be much easier to reduce materials costs by 3 percent than to increase sales revenues by 30 percent.

THE ROLE OF JUST-IN-TIME INVENTORY

Pioneered by Japanese firms during that country's remarkable economic transformation during the 1960s and 1970s, just-in-time inventory systems now play a major role in most manufacturing firms. The basic philosophy behind **just-in-time (JIT)** systems is to

economize on inventory holding costs by having materials arrive at a manufacturing plant just in time to enter the production process and not before. The major cost saving comes from speeding up inventory turnover. This reduces inventory holding costs, such as warehousing and storage costs. It means the company can reduce the amount of working capital it needs to finance inventory, freeing capital for other uses and/or lowering the total capital requirements of the enterprise. Other things being equal, this will boost the company's profitability as measured by return on capital invested. It also means the company is less likely to have excess unsold inventory that it has to write off against earnings or price low to sell.

In addition to the cost benefits, JIT systems can also help firms improve product quality. Under a JIT system, parts enter the manufacturing process immediately; they are not warehoused. This allows defective inputs to be spotted right away. The problem can then be traced to the supply source and fixed before more defective parts are produced. Under a more traditional system, warehousing parts for weeks before they are used allows many defective parts to be produced before a problem is recognized.

The drawback of a JIT system is that it leaves a firm without a buffer stock of inventory. Although buffer stocks are expensive to store, they can help a firm respond quickly to increases in demand and tide a firm over shortages brought about by disruption among suppliers. Such a disruption occurred after the September 11, 2001, attacks on the World Trade Center, when the subsequent shutdown of international air travel and shipping left many firms that relied upon globally dispersed suppliers and tightly managed "just-in-time" supply chains without a buffer stock of inventory. A less pronounced but similar situation occurred again in April 2003 when the outbreak of pneumonia-like SARS (severe acute respiratory syndrome) virus in China resulted in the temporary shutdown of several plants operated by foreign companies and disrupted their global supply chains. Similarly, in late 2004, record imports into the United States left several major West Coast shipping ports clogged with too many ships from Asia that could not be unloaded fast enough, and disrupted the finely tuned supply chains of several major U.S. enterprises.[37]

There are ways of reducing the risks associated with a global supply chain that operates on just-in-time principles. To reduce the risks associated with depending on one supplier for an important input, some firms source these inputs from several suppliers located in different countries. While this does not help in the case of an event with global ramifications, such as September 11, 2001, it does help manage country-specific supply disruptions, which are more common.

THE ROLE OF INFORMATION TECHNOLOGY AND THE INTERNET

Web-based information systems play a crucial role in modern materials management. By tracking component parts as they make their way across the globe toward an assembly plant, information systems enable a firm to optimize its production scheduling according to when components are expected to arrive. By locating component parts in the supply chain precisely, good information systems allow the firm to accelerate production when needed by pulling key components out of the regular supply chain and having them flown to the manufacturing plant.

Firms now typically use electronic data interchange (EDI) via the Internet to coordinate the flow of materials into manufacturing, through manufacturing, and out to customers. Sometimes customers also are integrated into the system. These electronic links are then used to place orders with suppliers, to register parts leaving a supplier, to track them as they travel toward a manufacturing plant, and to register their arrival. Suppliers typically use an EDI link to send invoices to the purchasing firm. One consequence of an EDI system is that suppliers, shippers, and the purchasing firm can communicate with each other with no time delay, which increases the flexibility and responsiveness of the whole global supply system. A second consequence is that much of the paperwork

between suppliers, shippers, and the purchasing firm is eliminated. Good EDI systems can help a firm decentralize materials management decisions to the plant level by giving corporate-level managers the information they need for coordinating and controlling decentralized materials management groups.

Before the emergence of the Internet as a major communication medium, firms and their suppliers normally had to purchase expensive proprietary software solutions to implement EDI systems. The ubiquity of the Internet and the availability of Web-based applications have made most of these proprietary solutions obsolete. Less expensive Web-based systems that are much easier to install and manage now dominate the market for global supply chain management software. These Web-based systems have transformed the management of globally dispersed supply chains, allowing even small firms to achieve a much better balance between supply and demand, thereby reducing the inventory in their systems and reaping the associated economic benefits. With many firms now using these systems, those that do not will find themselves at a competitive disadvantage.

CHAPTER SUMMARY

This chapter explained how efficient production and logistics functions can improve an international business's competitive position by lowering the costs of value creation and by performing value creation activities in such ways that customer service is enhanced and value added is maximized. We looked closely at three issues central to international production and logistics: where to produce, what to make and what to buy, and how to coordinate a globally dispersed manufacturing and supply system. The chapter made the following points:

1. The choice of an optimal production location must consider country factors, technological factors, and product factors.
2. Country factors include the influence of factor costs, political economy, and national culture on production costs, along with the presence of location externalities.
3. Technological factors include the fixed costs of setting up production facilities, the minimum efficient scale of production, and the availability of flexible manufacturing technologies that allow for mass customization.
4. Product factors include the value-to-weight ratio of the product and whether the product serves universal needs.
5. Location strategies either concentrate or decentralize manufacturing. The choice should be made in light of country, technological, and product factors. All location decisions involve trade-offs.
6. Foreign factories can improve their capabilities over time, and this can be of immense strategic benefit to the firm. Managers need to view foreign factories as potential centers of excellence and to encourage and foster attempts by local managers to upgrade factory capabilities.
7. An essential issue in many international businesses is determining which component parts should be manufactured in-house and which should be outsourced to independent suppliers.
8. Making components in-house facilitates investments in specialized assets and helps the firm protect its proprietary technology. It may improve scheduling between adjacent stages in the value chain also. In-house production also makes sense if the firm is an efficient, low-cost producer of a technology.
9. Buying components from independent suppliers facilitates strategic flexibility and helps the firm avoid the organizational problems associated with extensive vertical integration. Outsourcing might also be employed as part of an "offset" policy, which is designed to win more orders for the firm from a country by pushing some subcontracting work to that country.
10. Several firms have tried to attain the benefits of vertical integration and avoid its associated organizational problems by entering long-term strategic alliances with essential suppliers.
11. Although alliances with suppliers can give a firm the benefits of vertical integration without dispensing entirely with the benefits of a market relationship, alliances have drawbacks. The firm that enters a strategic alliance may find its

strategic flexibility limited by commitments to alliance partners.

12. Logistics encompasses all the activities that move materials to a production facility, through the production process, and out through a distribution system to the end user. The logistics function is complicated in an international business by distance, time, exchange rates, custom barriers, and other things.
13. Just-in-time systems generate major cost savings from reducing warehousing and inventory holding costs and from reducing the need to write off excess inventory. In addition, JIT systems help the firm spot defective parts and remove them from the manufacturing process quickly, thereby improving product quality.
14. Information technology, particularly Internet-based electronic data interchange, plays a major role in materials management. EDI facilitates the tracking of inputs, allows the firm to optimize its production schedule, lets the firm and its suppliers communicate in real time, and eliminates the flow of paperwork between a firm and its suppliers.

Critical Thinking and Discussion Questions

1. An electronics firm is considering how best to supply the world market for microprocessors used in consumer and industrial electronic products. A manufacturing plant costs about $500 million to construct and requires a highly skilled workforce. The total value of the world market for this product over the next 10 years is estimated to be between $10 billion and $15 billion. The tariffs prevailing in this industry are currently low. Should the firm adopt a concentrated or decentralized manufacturing strategy? What kind of location(s) should the firm favor for its plant(s)?
2. A chemical firm is considering how best to supply the world market for sulfuric acid. A manufacturing plant costs about $20 million to construct and requires a moderately skilled workforce. The total value of the world market for this product over the next 10 years is estimated to be between $20 billion and $30 billion. The tariffs prevailing in this industry are moderate. Should the firm favor concentrated manufacturing or decentralized manufacturing? What kind of location(s) should the firm seek for its plant(s)?
3. A firm must decide whether to make a component part in-house or to contract it out to an independent supplier. Manufacturing the part requires a nonrecoverable investment in specialized assets. The most efficient suppliers are located in countries with currencies that many foreign exchange analysts expect to appreciate substantially over the next decade. What are the pros and cons of *(a)* manufacturing the component in-house and *(b)* outsourcing manufacturing to an independent supplier? Which option would you recommend? Why?
4. Reread the Management Focus on Philips in China and then answer the following questions:
   a. What are the benefits to Philips of shifting so much of its global production to China?
   b. What are the risks associated with a heavy concentration of manufacturing assets in China?
   c. What strategies might Philips adopt to maximize the benefits and mitigate the risks associated with moving so much product
5. Explain how an efficient logistics function can help an international business compete more effectively in the global marketplace.

Research Task globalEDGE globaledge.msu.edu

Global Production, Outsourcing, and Logistics

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The globalization of production makes many people aware of the differences in manufacturing costs worldwide. The U.S. Department of Labor's Bureau of International Labor Affairs publishes a *Chartbook of International Labor Comparisons*. Locate the latest edition of this report and identify the hourly compensation costs for manufacturing workers in Australia, Germany, Mexico, Portugal, Singapore, and the United States.

Exercise 2

The internationalization of manufacturing has become predominant in the global marketplace. In fact, *Industry Week* magazine ranks the world's largest manufacturing companies by sales revenue. Identify the largest Finnish and South African manufacturing companies as provided in the most recent ranking by paying special attention to the industries in which these companies operate.

CLOSING CASE

The Rise of the Indian Automobile Industry

India is well on its way to becoming a small car manufacturing hub for some of the world's largest automobile companies. Between 2003 and 2008 automobile exports from India jumped fivefold to about 250,000 cars a year. Despite a global economic slowdown, exports are predicted to increase, reaching half a million vehicles a year by 2012. The leading Indian exporter is the Korean company Hyundai, which committed early to the Indian market. Hyundai began production in India in 1998, when consumers were only purchasing 300,000 cars a year, despite the country's population of almost 1 billion people. Hyundai invested in a plant in the southern city of Chennai with the capacity to turn out 100,000 cheap small cars a year. It had to train most of the workers from scratch, often giving them two years of on-the-job training before hiring them full time. Soon Hyundai's early investments were paying off, as India's emerging middle class snapped up its cars. Still the company had excess capacity, so it turned its attention to exports.

By 2004, Hyundai was the country's largest automobile exporter, shipping 70,000 cars a year overseas. Things have only improved for Hyundai since then. By 2008 Hyundai was making 500,000 cars a year in India and exporting over a third of them. It's smallest cars, the i10, are now produced only in India and are shipped mainly to Europe. The company plans to expand its Indian manufacturing capacity to 650,000, and ship up to half of its output overseas. In addition to Europe, Hyundai is now considering selling its Indian-made cars in the United States.

Hyundai's success has not gone unnoticed. Among other automakers, Suzuki and Nissan have also been investing aggressively in Indian factories. Suzuki exported about 50,000 cars from India in 2007 and hoped to increase that to 200,000 by 2010. Nissan also has big plans for India. It has invested some $1.1 billion in a new factory close to Hyundai's in Chennai. Completed in 2010, the factory has the capacity to make some 400,000 cars a year, about half of which will be exported. Ford, BMW, GM, and Toyota are also building, or planning to build, cars in India. A notable local competitor, Tata Motors, launched a low-cost "people's car," priced at $2,500, for the Indian market in 2009.

For all of these companies, India has several attractions. For one thing, the rapidly developing country has a potentially large domestic market. Also, labor costs are low compared to many other nations. Nissan, for example, notes that wage rates in India will be one-tenth of those in its Japanese factories. As Hyundai has shown, productivity is high and Indian workers can produce quality automobiles. Hyundai's executives claim that its Indian cars are of comparable quality to those produced in Korea. Nissan's goal is to use the same highly efficient flexible manufacturing processes in India as it uses in Japan. Nissan plans to send Indian workers to its Japanese factories for training on manufacturing processes and quality control.

India produces a large number of engineers every year, providing the professional skill base for designing cars and managing complex manufacturing facilities. Nissan intends to draw on this talent to design a low-cost small car to compete with Tata's "people's car." According to Nissan executives, the great advantage of Indian's engineers is that they are less likely to have the preconceptions of automobile engineers in developed nations, are more likely to "think outside of the box," and thus may be better equipped to handle the challenges of designing an ultra-low-cost small car.

Establishing manufacturing facilities in India does have problems, however. Nissan executives note that basic infrastructure is still lacking, roads are poor, and often clogged with everything from taxis and motorbikes to bullocks and carts, making the Japanese practice of just-in-time delivery hard to implement. It is also proving challenging to find local parts suppliers that can attain the same high-quality standards as those Nissan is used to elsewhere in the world. Nissan's strategy has been to work with promising local companies, helping them to raise their standards. For example, under the guidance of teams of engineers from Nissan, the Indian parts supplier Capro, which makes body panels, has built

a new factory near Nissan's Chennai facility, using the latest Japanese equipment. Workers there have also been trained in the Japanese practice of *kaizen*, or continuous process improvement.

Observers see the potential for Chennai to develop into the Detroit of India, with a cluster of automobile companies and parts suppliers working in the region producing high-quality, low-cost small cars that will not only sell well in the rapidly expanding Indian market, but could also sell well worldwide.[38]

Case Discussion Questions

1. What are the attractions of India as a base for producing automobiles both for domestic sale and for export to other nations?
2. Both Hyundai and Nissan made their investments in the southern Indian city of Chennai. What is the advantage to be had by investing in the same region as rivals?
3. What are the drawbacks of basing manufacturing in a country such as India? What other locations might be attractive?
4. If Hyundai, Nissan, their suppliers, and other automobile enterprises continue to make investments in the Chennai region of India, how might this region evolve over time? What does this suggest about manufacturing location strategy?

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18 Global Marketing and R&D

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Explain why it might make sense to vary the attributes of a product from country to country.
- **LO2** Recognize why and how a firm's distribution strategy might vary among countries.
- **LO3** Identify why and how advertising and promotional strategies might vary among countries.
- **LO4** Explain why and how a firm's pricing strategy might vary among countries.
- **LO5** Describe how the globalization of the world economy is affecting new-product development within the international business firm.

Ford's Marketing Goes Global

In recent years globalization has become a major thrust at Ford, the most successful of America's troubled automobile companies. The company has been pushing aggressively toward the development of global vehicles—models that share the same components, look the same, and are positioned the same way wherever they are sold. By 2015 all Ford vehicles competing in global segments should be common in North America, Europe, and Asia. They include the Fiesta and Focus small cars, Fusion and Mondeo midsize cars, and commercial vans.

To support this "One Ford" vision, Ford consolidated its national and regional product development activities into one organization in 2006 and charged it with creating global models. In the process, the company cut costs by hundreds of millions of dollars by eliminating overlap. Global purchasing operations were consolidated in 2008, again for large cost savings both from eliminating duplication and from the pricing power associated with purchasing components on a large scale. In 2009, a global marketing, sales, and service organization was created to integrate and drive a more consistent and compelling connection with customers around the world.

In the past, Ford's marketing departments in different countries had the authority to create their own programs and often did so in a vacuum without coordinating with marketers in other countries. The result was not only high costs from extensive duplication of everything from TV commercials and photo sessions to public relations events, but also a lack of consistency in marketing message and public relations strategy. Now Ford is insisting that marketing managers from different countries and regions communicate with each other before developing a marketing strategy for a vehicle.

The goal is not to have an identical marketing strategy for each country, but to have greater commonalities and



synergies, to learn from each other, leveraging good ideas while reducing the duplication of effort. Thus, for example, instead of hiring different photographers to shoot different pictures of the same car in different countries, Ford will use one photographer to shoot pictures for the entire world.

The launch of the 2011 Ford Focus is the first example of this execution. Marketers from around the world have cooperated on developing a marketing strategy. The car went on sale in China and Europe in the fall of 2009 and in the United States in 2010. Ten years ago, Ford used up to 15 advertising campaigns for individual countries when it launched the Focus globally and a number of different ad agencies. This time it used fewer than 10 campaigns, and they look much more like each other, sharing common themes. The same agency is coordinating and developing messages worldwide. The idea is to develop core messages that work in all markets, and then to tweak those messages to account for differences in local culture. While Ford recognizes that country differences are still important, it does not want to use totally different messages. Rather, it is trying to develop a common set of marketing tools that can be used in different ways in different countries.

Marketers in the United States watched how the Chinese "seeded" the new Ford Focus by giving it to early "influencers" who then wrote about it on social networking websites. In China, where traditional advertising is still not well developed, Internet-based social media campaigns can (and did) spark interest. The marketers then decided to adopt a similar viral marketing strategy in the United States. The result was the "Fiesta Movement," a web-centric exercise in viral marketing revolving around 100 "agents" who were given early versions of the 2011 Focus and required to blog about it.[1]

Introduction

The previous chapter looked at the roles of global production and logistics in an international business. This chapter continues our focus on specific business functions by examining the roles of marketing and research and development (R&D) in an international business. We focus on how marketing and R&D can be performed so they will reduce the costs of value creation and add value by better serving customer needs.

In Chapter 13 we spoke of the tension existing in most international businesses between the need to reduce costs and at the same time to respond to local conditions, which tends to raise costs. This tension continues to be a persistent theme in this chapter. A global marketing strategy that views the world's consumers as similar in their tastes and preferences is consistent with the mass production of a standardized output. By mass-producing a standardized output, whether it be soap or semiconductor chips, the firm can realize substantial unit cost reductions from experience curve and other economies of scale. However, ignoring country differences in consumer tastes and preferences can lead to failure. Thus, an international business's marketing function needs to determine when product standardization is appropriate and when it is not, and to adjust the marketing strategy accordingly. Even if product standardization is appropriate, the way in which a product is positioned in a market and the promotions and messages used to sell that product may still have to be customized so that they resonate with local consumers.

As described in the opening case, Ford is dealing with just these issues. In 2006 the company consolidated its different national and regional product development activities into one organization, and in 2009 it did the same with marketing. The goal has been to create "One Ford," a company that develops and sells the same cars to the same market segments worldwide. A driving force behind the One Ford vision has been the idea to reduce costs. At the same time, Ford does recognize that difference across countries in tastes and preferences, and in culture, are still significant. Accordingly, while it seeks to develop common marketing themes that are used worldwide for new models, such as the 2011 Ford Focus, local markets have retained the authority to "tweak" those themes, and the ways in which they are presented, so that they are attuned to local conditions.

We consider marketing and R&D within the same chapter because of their close relationship. A critical aspect of the marketing function is identifying gaps in the market so that the firm can develop new products to fill those gaps. Developing new products requires R&D; thus, the linkage between marketing and R&D. A firm should develop new products with market needs in mind, and only marketing can define those needs for R&D personnel. Also, only marketing can tell R&D whether to produce globally standardized or locally customized products. Research has long maintained that a major contributor to the success of new-product introductions is a close relationship between marketing and R&D.[2]

In this chapter, we begin by reviewing the debate on the globalization of markets. Then we discuss the issue of market segmentation. Next we look at four elements that constitute a firm's marketing mix: product attributes, distribution strategy, communication strategy, and pricing strategy. The **marketing mix** is the set of choices the firm offers to its targeted markets. Many firms vary their marketing mix from country to country, depending on differences in national culture, economic development, product standards, distribution channels, and so on.

The chapter closes with a look at new-product development in an international business and at the implications of this for the organization of the firm's R&D function.

The Globalization of Markets and Brands

In a now-classic *Harvard Business Review* article, the late Theodore Levitt wrote lyrically about the globalization of world markets. Levitt's arguments have become something of a lightning rod in the debate about the extent of globalization. According to Levitt,

> A powerful force drives the world toward a converging commonalty, and that force is technology. It has proletarianized communication, transport, and travel. The result is a new commercial reality—the emergence of global markets for standardized consumer products on a previously unimagined scale of magnitude.
>
> Gone are accustomed differences in national or regional preferences. The globalization of markets is at hand. With that, the multinational commercial world nears its end, and so does the multinational corporation. The multinational corporation operates in a number of countries and adjusts its products and practices to each—at high relative costs. The global corporation operates with resolute consistency—at low relative cost—as if the entire world were a single entity; it sells the same thing in the same way everywhere.
>
> Commercially, nothing confirms this as much as the success of McDonald's from the Champs Élysées to the Ginza, of Coca-Cola in Bahrain and Pepsi-Cola in Moscow, and of rock music, Greek salad, Hollywood movies, Revlon cosmetics, Sony television, and Levi's jeans everywhere.
>
> Ancient differences in national tastes or modes of doing business disappear. The commonalty of preference leads inescapably to the standardization of products, manufacturing, and the institutions of trade and commerce.[3]

This is eloquent and evocative writing, but is Levitt correct? The rise of the global media phenomenon from CNN to MTV, and the ability of such media to help shape a global culture, would seem to lend weight to Levitt's argument. If Levitt is correct, his argument has major implications for the marketing strategies pursued by international business. However, many academics feel that Levitt overstates his case.[4] Although Levitt may have a point when it comes to many basic industrial products, such as steel, bulk chemicals, and semiconductor chips, globalization in the sense used by Levitt seems to be the exception rather than the rule in many consumer goods markets and industrial markets. Even a firm such as McDonald's, which Levitt holds up as the archetypal example of a consumer products firm that sells a standardized product worldwide, modifies its menu from country to country in light of local consumer preferences. In the Middle East, for example, McDonald's sells the McArabia, a chicken sandwich on Arabian-style bread, and in France, the Croque McDo, a hot ham and cheese sandwich.[5]

On the other hand, Levitt is probably correct to assert that modern transportation and communications technologies are facilitating a convergence of certain tastes and preferences among consumers in the more advanced countries of the world, and this has become even more prevalent since he wrote. The popularity of sushi in Los Angeles, hamburgers in Tokyo, hip-hop music, and global media phenomena such as MTV all support this contention. In the long run, such technological forces may lead to the evolution of a global culture. At present, however, the continuing persistence of cultural and economic differences between nations acts as a brake on any trend toward the standardization of consumer tastes and preferences across nations. Indeed, that may never occur. Some writers have argued that the rise of global culture doesn't mean that consumers share the same tastes and preferences.[6] Rather, people in different nations, often with conflicting viewpoints, are increasingly participating in a shared "global" conversation, drawing upon shared symbols that include global brands from Nike and Dove to Coca-Cola and Sony. But the way in which these brands are perceived, promoted, and used still varies from country to country, depending upon local differences in tastes and preferences. Furthermore, trade barriers and differences in product and technical standards also constrain a firm's ability to sell a standardized product to a global market using a standardized marketing strategy. We discuss the sources of these differences in subsequent sections when we look at how products must be altered from country to country. In short, Levitt's globally standardized markets seem a long way off in many industries.

Market Segmentation

Market segmentation refers to identifying distinct groups of consumers whose purchasing behavior differs from others in important ways. Markets can be segmented in numerous ways: by geography, demography (sex, age, income, race, education level, etc.),

sociocultural factors (social class, values, religion, lifestyle choices), and psychological factors (personality). Because different segments exhibit different patterns of purchasing behavior, firms often adjust their marketing mix from segment to segment. Thus, the precise design of a product, the pricing strategy, the distribution channels used, and the choice of communication strategy may all be varied from segment to segment. The goal is to optimize the fit between the purchasing behavior of consumers in a given segment and the marketing mix, thereby maximizing sales to that segment. Automobile companies, for example, use a different marketing mix to sell cars to different socioeconomic segments. Thus, Toyota uses its Lexus division to sell high-priced luxury cars to high-income consumers, while selling its entry-level models, such as the Toyota Corolla, to lower-income consumers. Similarly, personal computer manufacturers will offer different computer models, embodying different combinations of product attributes and price points, precisely to appeal to consumers from different market segments (e.g., business users and home users).

When managers in an international business consider market segmentation in foreign countries, they need to be cognizant of two main issues: the differences between countries in the structure of market segments and the existence of segments that transcend national borders. The structure of market segments may differ significantly from country to country. An important market segment in a foreign country may have no parallel in the firm's home country, and vice versa. The firm may have to develop a unique marketing mix to appeal to the purchasing behavior of a certain segment in a given country. An example of such a market segment is given in the accompanying Management Focus, which looks at the African-Brazilian market segment in Brazil, which as you will see is very different from the African-American segment in the United States. In another example, a research project identified a segment of consumers in China in the 50-to-60 age range that has few parallels in other countries.[7] This group came of age during China's Cultural Revolution in the late 1960s and early 1970s. This group's values have been shaped by their experiences during the Cultural Revolution. They tend to be highly sensitive to price and respond negatively to new products and most forms of marketing. Thus, firms doing business in China may need to customize their marketing mix to address the unique values and purchasing behavior of the group. The existence of such a segment constrains the ability of firms to standardize their global marketing strategy.

In contrast, the existence of market segments that transcend national borders clearly enhances the ability of an international business to view the global marketplace as a single entity and pursue a global strategy, selling a standardized product worldwide and using the same basic marketing mix to help position and sell that product in a variety of national markets. For a segment to transcend national borders, consumers in that segment must have some compelling similarities along important dimensions—such as age, values, lifestyle choices—and those similarities must translate into similar purchasing behavior. Although such segments clearly exist in certain industrial markets, they are somewhat rarer in consumer markets. One emerging global segment that is attracting the attention of international marketers of consumer goods is the so-called global youth segment. Global media are paving the way for a global youth segment. Evidence that such a segment exists comes from a study of the cultural attitudes and purchasing behavior of more than 6,500 teenagers in 26 countries.[8] The findings suggest that teens around the world are increasingly living parallel lives that share many common values. It follows that they are likely to purchase the same kind of consumer goods and for the same reasons.

Product Attributes

A product can be viewed as a bundle of attributes.[9] For example, the attributes that make up a car include power, design, quality, performance, fuel consumption, and comfort; the attributes of a hamburger include taste, texture, and size; a hotel's attributes

MANAGEMENT FOCUS

Marketing to Black Brazil

Brazil is home to the largest black population outside of Nigeria. Nearly half of the 160 million people in Brazil are of African or mixed race origin. Despite this, until recently businesses have made little effort to target this numerically large segment. Part of the reason is rooted in economics. Black Brazilians have historically been poorer than Brazilians of European origin and thus have not received the same attention as whites. But after a decade of relatively strong economic performance in Brazil, an emerging black middle class is beginning to command the attention of consumer product companies. To take advantage of this, companies such as Unilever have introduced a range of skin care products and cosmetics aimed at black Brazilians, and Brazil's largest toy company has introduced a black Barbie-like doll, Susi Olodum, sales of which quickly caught up with sales of a similar white doll.

But there is more to the issue than simple economics. Unlike the United States, where a protracted history of racial discrimination gave birth to the civil rights movement, fostered black awareness, and produced an identifiable subculture in U.S. society, the history of blacks in Brazil has been very different. Although Brazil did not abolish slavery until 1888, racism in Brazil has historically been much subtler than in the United States. Brazil has never excluded blacks from voting or had a tradition of segregating the races. Historically, too, the government encouraged intermarriage between whites and blacks in order to "bleach" society. Partly due to this more benign history, Brazil has not had a black rights movement similar to that in the United States, and racial self-identification is much weaker. Surveys routinely find that African-Brazilian consumers decline to categorize themselves as either black or white; instead they choose one of dozens of skin tones and see themselves as being part of a culture that transcends race.

This subtler racial dynamic has important implications for market segmentation and tailoring the marketing mix in Brazil. Unilever had to face this issue when launching a Vaseline Intensive Care lotion for black consumers in Brazil. The company learned in focus groups that for the product to resonate with nonwhite women, its promotions had to feature women of different skin tones, excluding neither whites nor blacks. The campaign Unilever devised features three women with different skin shades at a fitness center. The bottle says the lotion is for "tan and black skin," a description that could include many white women considering that much of the population lives near the beach. Unilever learned that the segment exists, but it is more difficult to define and requires more subtle marketing messages than the African-American segment in the United States or middle-class segments in Africa.[10]

include atmosphere, quality, comfort, and service. Products sell well when their attributes match consumer needs (and when their prices are appropriate). BMW cars sell well to people who have high needs for luxury, quality, and performance, precisely because BMW builds those attributes into its cars. If consumer needs were the same the world over, a firm could simply sell the same product worldwide. However, consumer needs vary from country to country, depending on culture and the level of economic development. A firm's ability to sell the same product worldwide is further constrained by countries' differing product standards. This section reviews each of these issues and discusses how they influence product attributes.

CULTURAL DIFFERENCES

We discussed countries' cultural differences in Chapter 3. Countries differ along a whole range of dimensions, including social structure, language, religion, and education. These differences have important implications for marketing strategy. For example, hamburgers do not sell well in Islamic countries, where the consumption of ham is forbidden by Islamic law. The most important aspect of cultural differences is probably the impact of tradition. Tradition is particularly important in foodstuffs and beverages. For example, reflecting differences in traditional eating habits, the Findus frozen food



Tastes and preferences vary from country to country. To suit its global customers, Coca-Cola has a wide variety of products, such as Georgia, which is sold in Japan.

division of Nestlé, the Swiss food giant, markets fish cakes and fish fingers in Great Britain, but beef bourguignon and coq au vin in France and vitéllo con funghi and braviola in Italy. In addition to its normal range of products, Coca-Cola in Japan markets Georgia, a cold coffee in a can, and Aquarius, a tonic drink, both of which appeal to traditional Japanese tastes.

For historical and idiosyncratic reasons, a range of other cultural differences exist between countries. For example, scent preferences differ from one country to another. SC Johnson, a manufacturer of waxes and polishes, encountered resistance to its lemon-scented Pledge furniture polish among older consumers in Japan. Careful market research revealed the polish smelled similar to a latrine disinfectant used widely in Japan. Sales rose sharply after the scent was adjusted.[11] In another example, Cheetos, the bright orange and cheesy-tasting snack from PepsiCo's Frito-Lay unit, do not have a cheese taste in China. Chinese consumers generally do not like the taste of cheese because it has never been part of traditional cuisine and because many Chinese are lactose-intolerant.[12]

There is some evidence of the trends Levitt talked about. Tastes and preferences are becoming more cosmopolitan. Coffee is gaining ground against tea in Japan and Great Britain, while American-style frozen dinners have become popular in Europe (with some fine-tuning to local tastes). Taking advantage of these trends, Nestlé has found that it can market its instant coffee, spaghetti bolognese, and Lean Cuisine frozen dinners in essentially the same manner in both North America and Western Europe. However, there is no market for Lean Cuisine dinners in most of the rest of the world, and there may not be for years or decades. Although some cultural convergence has occurred, particularly among the advanced industrial nations of North America and Western Europe, Levitt's global culture characterized by standardized tastes and preferences is still a long way off.

ECONOMIC DEVELOPMENT

Just as important as differences in culture are differences in the level of economic development. We discussed the extent of country differences in economic development in Chapter 2. Consumer behavior is influenced by the level of economic development of a country. Firms based in highly developed countries such as the United States tend to build a lot of extra performance attributes into their products. These extra attributes are not usually demanded by consumers in less developed nations, where the preference is for more basic products. Thus, cars sold in less developed nations typically lack many of the features found in developed nations, such as air-conditioning, power steering, power windows, radios, and cassette players. For most consumer durables, product reliability may be a more important attribute in less developed nations, where such a purchase may account for a major proportion of a consumer's income, than it is in advanced nations.

Contrary to Levitt's suggestions, consumers in the most developed countries are often not willing to sacrifice their preferred attributes for lower prices. Consumers in the most advanced countries often shun globally standardized products that have been developed with the lowest common denominator in mind. They are willing to pay more for products that have additional features and attributes customized to their tastes and preferences. For example, demand for top-of-the-line four-wheel-drive sport utility vehicles, such as Chrysler's Jeep, Ford's Explorer, and Toyota's Land Cruiser, has been largely restricted to the United States. This is due to a combination of factors, including the

high income level of U.S. consumers, the country's vast distances, the relatively low cost of gasoline, and the culturally grounded "outdoor" theme of American life.

PRODUCT AND TECHNICAL STANDARDS

Even with the forces that are creating some convergence of consumer tastes and preferences among advanced, industrialized nations, Levitt's vision of global markets may still be a long way off because of national differences in product and technological standards.

Differing government-mandated product standards can rule out mass production and marketing of a standardized product. Differences in technical standards also constrain the globalization of markets. Some of these differences result from idiosyncratic decisions made long ago, rather than from government actions, but their long-term effects are profound. For example, DVD equipment manufactured for sale in the United States will not play DVDs recorded on equipment manufactured for sale in Great Britain, Germany, and France (and vice versa). Different technical standards for television signal frequency emerged in the 1950s that require television and video equipment to be customized to prevailing standards. RCA stumbled in the 1970s when it failed to account for this in its marketing of TVs in Asia. Although several Asian countries adopted the U.S. standard, Singapore, Hong Kong, and Malaysia adopted the British standard. People who bought RCA TVs in those countries could receive a picture but no sound![13]

Distribution Strategy

A critical element of a firm's marketing mix is its distribution strategy: the means it chooses for delivering the product to the consumer. The way the product is delivered is determined by the firm's entry strategy, discussed in Chapter 15. This section examines a typical distribution system, discusses how its structure varies between countries, and looks at how appropriate distribution strategies vary from country to country.

Figure 18.1 illustrates a typical distribution system consisting of a channel that includes a wholesale distributor and a retailer. If the firm manufactures its product in the particular country, it can sell directly to the consumer, to the retailer, or to the wholesaler.

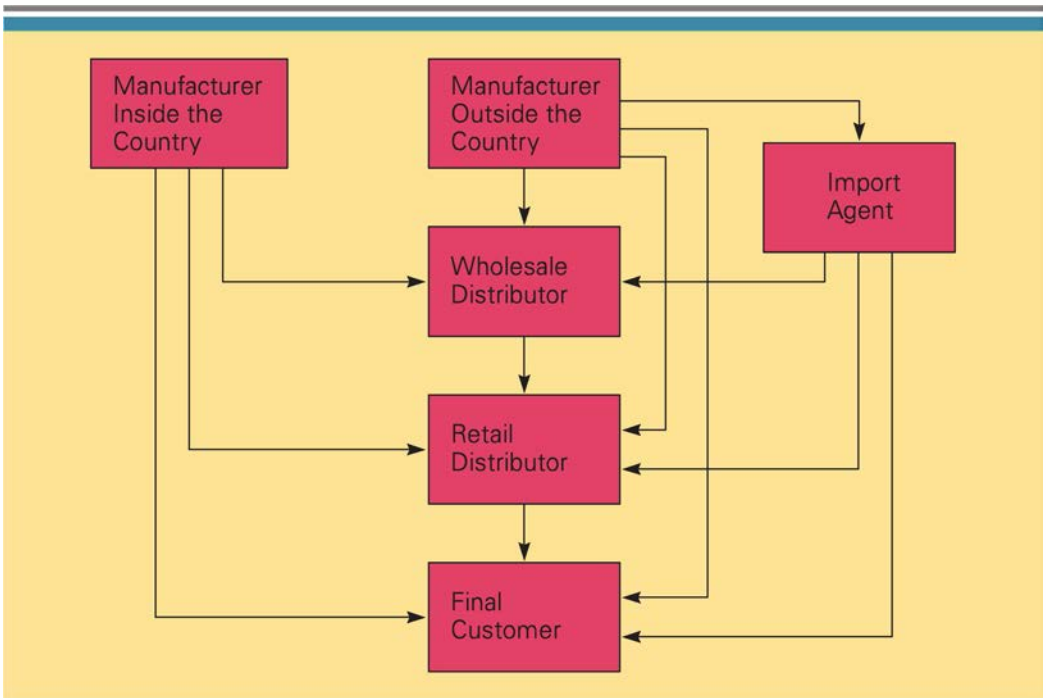


FIGURE 18.1

A Typical Distribution System

The same options are available to a firm that manufactures outside the country. Plus, this firm may decide to sell to an import agent, which then deals with the wholesale distributor, the retailer, or the consumer. Later in the chapter we will consider the factors that determine the firm's choice of channel.

DIFFERENCES BETWEEN COUNTRIES

The four main differences between distribution systems are retail concentration, channel length, channel exclusivity, and channel quality.

Retail Concentration

In some countries, the retail system is very concentrated, but it is fragmented in others. In a **concentrated retail system**, a few retailers supply most of the market. A **fragmented retail system** is one in which there are many retailers, no one of which has a major share of the market. Many of the differences in concentration are rooted in history and tradition. In the United States, the importance of the automobile and the relative youth of many urban areas have resulted in a retail system centered on large stores or shopping malls to which people can drive. This has facilitated system concentration. Japan, with a much greater population density and a large number of urban centers that grew up before the automobile, has a more fragmented retail system, with many small stores serving local neighborhoods and to which people frequently walk. In addition, the Japanese legal system protects small retailers. Small retailers can try to block the establishment of a large retail outlet by petitioning their local government.

There is a tendency for greater retail concentration in developed countries. Three factors that contribute to this are the increases in car ownership, number of households with refrigerators and freezers, and number of two-income households. All these factors have changed shopping habits and facilitated the growth of large retail establishments sited away from traditional shopping areas. The last decade has seen consolidation in the global retail industry, with companies such as Walmart and Carrefour attempting to become global retailers by acquiring retailers in different countries. This has increased retail concentration.

In contrast, retail systems are very fragmented in many developing countries, which can make for interesting distribution challenges. In rural China, large areas of the country can be reached only by traveling rutted dirt roads. In India, Unilever has to sell to retailers in 600,000 rural villages, many of which cannot be accessed via paved roads, which means products can reach their destination only by bullock, bicycle, or cart. In neighboring Nepal, the terrain is so rugged that even bicycles and carts are not practical, and businesses rely on yak trains and the human back to deliver products to thousands of small retailers.

Channel Length

Channel length refers to the number of intermediaries between the producer (or manufacturer) and the consumer. If the producer sells directly to the consumer, the channel is very short. If the producer sells through an import agent, a wholesaler, and a retailer, a long channel exists. The choice of a short or long channel is in part a strategic decision for the producing firm. However, some countries have longer distribution channels than others. The most important determinant of channel length is the degree to which the retail system is fragmented. Fragmented retail systems tend to promote the growth of wholesalers to serve retailers, which lengthens channels.

The more fragmented the retail system, the more expensive it is for a firm to make contact with each individual retailer. Imagine a firm that sells toothpaste in a country where there are more than a million small retailers, as in rural India and China. To sell directly to the retailers, the firm would have to build a huge sales force. This would be very expensive, particularly since each sales call would yield a very small order. But

suppose a few hundred wholesalers in the country supply retailers not only with toothpaste but also with all other personal care and household products. Because these wholesalers carry a wide range of products, they get bigger orders with each sales call, making it worthwhile for them to deal directly with the retailers. Accordingly, it makes economic sense for the firm to sell to the wholesalers and the wholesalers to deal with the retailers.

Because of such factors, countries with fragmented retail systems also tend to have long channels of distribution, sometimes with multiple layers. The classic example is Japan, where there are often two or three layers of wholesalers between the firm and retail outlets. In countries such as Great Britain, Germany, and the United States where the retail system is far more concentrated, channels are much shorter. When the retail sector is very concentrated, it makes sense for the firm to deal directly with retailers, cutting out wholesalers. A relatively small sales force is required to deal with a concentrated retail sector, and the orders generated from each sales call can be large. Such circumstances tend to prevail in the United States, where large food companies may sell directly to supermarkets rather than going through wholesale distributors.

The rapid development of the Internet in recent years has helped to shorten channel length. For example, the Seattle-based outdoor equipment retailer REI sells its products in Japan via a Japanese-language website, thereby eliminating the need for a retail presence on the ground in Japan, which obviously shortens the channel length between REI and its customers. However, there are definite drawbacks with such a strategy. In the case of REI, consumers cannot receive the same level of advice over the Internet as in physical retail stores, where salespeople can help customers choose the right gear for their needs. So although REI benefits from a short channel in Japan, it may lose significant sales due to the lack of point-of-sale service.

Another factor that is shortening channel length in some counties is the entry of large discount superstores, such as Carrefour, Walmart, and Tesco. The business model of these retailers is in part based upon the idea that in an attempt to lower prices, they cut out wholesalers and instead deal directly with manufacturers. Thus, when Walmart entered Mexico, its policy of dealing directly with manufacturers, instead of buying merchandise through wholesalers, helped to shorten distribution channels in that nation. Similarly, Japan's historically long distribution channels are now being shortened by the rise of large retailers, some of them foreign owned, such as Toys "R" Us, and some of them indigenous enterprises that are imitating the American model, all of which are progressively cutting out wholesalers and dealing directly with manufacturers.

Channel Exclusivity

An **exclusive distribution channel** is one that is difficult for outsiders to access. For example, it is often difficult for a new firm to get access to shelf space in supermarkets. This occurs because retailers tend to prefer to carry the products of established manufacturers of foodstuffs with national reputations rather than gamble on the products of unknown firms. The exclusivity of a distribution system varies between countries. Japan's system is often held up as an example of a very exclusive system. In Japan, relationships between manufacturers, wholesalers, and retailers often go back decades. Many of these relationships are based on the understanding that distributors will not carry the products of competing firms. In return, the distributors are guaranteed an attractive markup by the manufacturer. As many U.S. and European manufacturers have learned, the close ties that result from this arrangement can make access to the Japanese market difficult. However, it is possible to break into the Japanese market with a new consumer product. Procter & Gamble did during the 1990s with its Joy brand of dish soap. P&G was able to overcome a tradition of exclusivity for two reasons. First, after a decade of lackluster economic performance, Japan is changing. In their search for profits, retailers are far more willing than they have been historically to violate the old norms of exclusivity. Second, P&G has been in Japan long enough and has a broad enough portfolio of

consumer products to give it considerable leverage with distributors, enabling it to push new products out through the distribution channel.

Channel Quality

Channel quality refers to the expertise, competencies, and skills of established retailers in a nation, and their ability to sell and support the products of international businesses. Although the quality of retailers is good in most developed nations, in emerging markets and less developed nations from Russia to Indonesia, channel quality is variable at best. The lack of a high-quality channel may impede market entry, particularly in the case of new or sophisticated products that require significant point-of-sale assistance and after-sales services and support. When channel quality is poor, an international business may have to devote considerable attention to upgrading the channel, for example, by providing extensive education and support to existing retailers, and in extreme cases by establishing its own channel. Thus, after pioneering its Apple retail store concept in the United States, Apple is opening retail stores in several nations, such as the United Kingdom, to provide point-of-sales education, service, and support for its popular iPod and computer products. Apple believes that this strategy will help it to gain market share in these nations.

CHOOSING A DISTRIBUTION STRATEGY

A choice of distribution strategy determines which channel the firm will use to reach potential consumers. Should the firm try to sell directly to the consumer or should it go through retailers; should it go through a wholesaler; should it use an import agent; or should it invest in establishing its own channel? The optimal strategy is determined by the relative costs and benefits of each alternative, which vary from country to country, depending on the four factors we have just discussed: retail concentration, channel length, channel exclusivity, and channel quality.

Because each intermediary in a channel adds its own markup to the products, there is generally a critical link between channel length, the final selling price, and the firm's profit margin. The longer a channel, the greater the aggregate markup, and the higher the price that consumers are charged for the final product. To ensure that prices do not get too high as a result of markups by multiple intermediaries, a firm might be forced to operate with lower profit margins. Thus, if price is an important competitive weapon, and if the firm does not want to see its profit margins squeezed, other things being equal, the firm would prefer to use a shorter channel.

However, the benefits of using a longer channel may outweigh these drawbacks. As we have seen, one benefit of a longer channel is that it cuts selling costs when the retail sector is very fragmented. Thus, it makes sense for an international business to use longer channels in countries where the retail sector is fragmented and shorter channels in countries where the retail sector is concentrated. Another benefit of using a longer channel is market access—the ability to enter an exclusive channel. Import agents may have long-term relationships with wholesalers, retailers, or important consumers and thus be better able to win orders and get access to a distribution system. Similarly, wholesalers may have long-standing relationships with retailers and be better able to persuade them to carry the firm's product than the firm itself would.

Import agents are not limited to independent trading houses; any firm with a strong local reputation could serve as well. For example, to break down channel exclusivity and gain greater access to the Japanese market, Apple Computer signed distribution agreements with five large Japanese firms, including business equipment giant Brother Industries, stationery leader Kokuyo, Mitsubishi, Sharp, and Minolta. These firms use their own long-established distribution relationships with consumers, retailers, and wholesalers to push Apple computers through the Japanese distribution system. As a result, Apple's share of the Japanese market increased from less than 1 percent to 13 percent in the four years following the signing of the agreements.[14]

If such an arrangement is not possible, the firm might want to consider other, less traditional alternatives to gaining market access. Frustrated by channel exclusivity in Japan, some foreign manufacturers of consumer goods have attempted to sell directly to Japanese consumers using direct mail and catalogs. REI had trouble persuading Japanese wholesalers and retailers to carry its products, so it began a direct-mail campaign and then a web-based strategy to enter Japan that is proving successful.

Finally, if channel quality is poor, a firm should consider what steps it could take to upgrade the quality of the channel, including establishing its own distribution channel.

Communication Strategy

Another critical element in the marketing mix is communicating the attributes of the product to prospective customers. A number of communication channels are available to a firm, including direct selling, sales promotion, direct marketing, and advertising. A firm's communication strategy is partly defined by its choice of channel. Some firms rely primarily on direct selling, others on point-of-sale promotions or direct marketing, and others on mass advertising; still others use several channels simultaneously to communicate their message to prospective customers. This section looks first at the barriers to international communication. Then we will survey the various factors that determine which communication strategy is most appropriate in a particular country. After that we discuss global advertising.

BARRIERS TO INTERNATIONAL COMMUNICATION

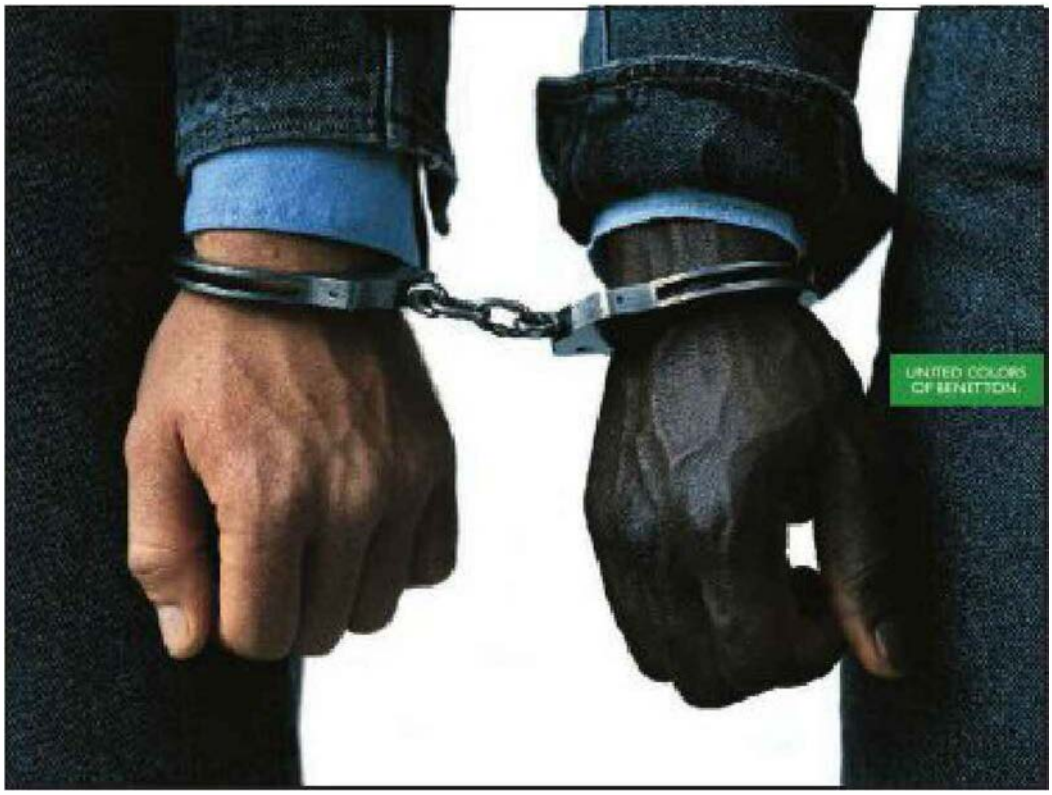
International communication occurs whenever a firm uses a marketing message to sell its products in another country. The effectiveness of a firm's international communication can be jeopardized by three potentially critical variables: cultural barriers, source effects, and noise levels.

Cultural Barriers

Cultural barriers can make it difficult to communicate messages across cultures. We discussed some sources and consequences of cultural differences between nations in Chapter 3 and in the previous section of this chapter. Because of cultural differences, a message that means one thing in one country may mean something quite different in another. For example, when Procter & Gamble first promoted its Camay soap in Japan, it ran into unexpected trouble. In a TV commercial, a Japanese man walked into the bathroom while his wife was bathing. The woman began telling her husband all about her new soap, but the husband, stroking her shoulder, hinted that suds were not on his mind. This ad had been popular in Europe, but it flopped in Japan because it is considered bad manners there for a man to intrude on his wife.[15]

Benetton, the Italian clothing manufacturer and retailer, is another firm that has run into cultural problems with its advertising. The company launched a worldwide advertising campaign with the theme "United Colors of Benetton" that had won awards in France. One of its ads featured a black woman breast-feeding a white baby, and another one showed a black man and a white man handcuffed together. Benetton was surprised when the ads were attacked by U.S. civil rights groups for promoting white racial domination. Benetton withdrew its ads and fired its advertising agency, Eldorado of France.

The best way for a firm to overcome cultural barriers is to develop cross-cultural literacy (see Chapter 4). In addition, it should use local input, such as a local advertising agency, in developing its marketing message. If the firm uses direct selling rather than advertising to communicate its message, it should develop a local sales force whenever possible. Cultural differences limit a firm's ability to use the same marketing message and selling approach worldwide. What works well in one country may be offensive in another.



Clothing retailer Benetton has become famous for controversial ads, such as this one, which some countries have refused to run because they were deemed offensive or inappropriate.

Source and Country of Origin Effects

Source effects occur when the receiver of the message (the potential consumer in this case) evaluates the message on the basis of status or image of the sender. Source effects can be damaging for an international business when potential consumers in a target country have a bias against foreign firms. For example, a wave of "Japan bashing" swept the United States in the early 1990s. Worried that U.S. consumers might view its products negatively, Honda responded by creating ads that emphasized the U.S. content of its cars to show how "American" the company had become.

Many international businesses try to counter negative source effects by deemphasizing their foreign origins. When the French antiglobalization protester Jose Bove was hailed as a hero by some in France for razing a partly built McDonald's in 1999, the French franchisee of McDonald's responded with an ad depicting a fat, ignorant American who could not understand why McDonald's France used locally produced food that wasn't genetically modified. The edgy ad worked, and McDonald's French operations are now among the most robust in the company's global network.[16] Similarly, when British Petroleum acquired Mobil Oil's extensive network of U.S. gas stations, it changed its name to BP, diverting attention away from the fact that one of the biggest operators of gas stations in the United States is a British firm.

A subset of source effects is referred to as **country of origin effects**, or the extent to which the place of manufacturing influences product evaluations. Research suggests that the consumer may use country of origin as a cue when evaluating a product, particularly if he or she lacks more detailed knowledge of the product. For example, one study found that Japanese consumers tended to rate Japanese products more favorably than U.S. products across multiple dimensions, even when independent analysis showed that they were actually inferior.[17] When a negative country of origin effect exists, an international business may have to work hard to counteract this effect by, for example, using promotional messages that stress the positive performance attributes of its product. Thus, the South Korean automobile company Hyundai tried to overcome negative perceptions

about the quality of its vehicle in the United States by running advertisements that favorably compare the company's cars to more prestigious brands.

Source effects and country of origin effects are not always negative. French wine, Italian clothes, and German luxury cars benefit from nearly universal positive source effects. In such cases, it may pay a firm to emphasize its foreign origins. In Japan, for example, there is strong demand for high-quality foreign goods, particularly those from Europe. It has become chic to carry a Gucci handbag, sport a Rolex watch, drink expensive French wine, and drive a BMW.

Noise Levels

Noise tends to reduce the probability of effective communication. **Noise** refers to the amount of other messages competing for a potential consumer's attention, and this too varies across countries. In highly developed countries such as the United States, noise is extremely high. Fewer firms vie for the attention of prospective customers in developing countries, thus the noise level is lower.

PUSH VERSUS PULL STRATEGIES

The main decision with regard to communications strategy is the choice between a push strategy and a pull strategy. A **push strategy** emphasizes personal selling rather than mass media advertising in the promotional mix. Although effective as a promotional tool, personal selling requires intensive use of a sales force and is relatively costly. A **pull strategy** depends more on mass media advertising to communicate the marketing message to potential consumers.

Although some firms employ only a pull strategy and others only a push strategy, still other firms combine direct selling with mass advertising to maximize communication effectiveness. Factors that determine the relative attractiveness of push and pull strategies include product type relative to consumer sophistication, channel length, and media availability.

Product Type and Consumer Sophistication

Firms in consumer goods industries that are trying to sell to a large segment of the market generally favor a pull strategy. Mass communication has cost advantages for such firms, thus they rarely use direct selling. Exceptions can be found in poorer nations with low literacy levels, where direct selling may be the only way to reach consumers (see the Management Focus on Unilever). Firms that sell industrial products or other complex products favor a push strategy. Direct selling allows the firm to educate potential consumers about the features of the product. This may not be necessary in advanced nations where a complex product has been in use for some time, where the product's attributes are well understood, where consumers are sophisticated, and where high-quality channels exist that can provide point-of-sale assistance. However, customer education may be important when consumers have less sophistication toward the product, which can be the case in developing nations or in advanced nations when a new complex product is being introduced, or where high-quality channels are absent or scarce.

Channel Length

The longer the distribution channel, the more intermediaries there are that must be persuaded to carry the product for it to reach the consumer. This can lead to inertia in the channel, which can make entry difficult. Using direct selling to push a product through many layers of a distribution channel can be expensive. In such circumstances, a firm may try to pull its product through the channels by using mass advertising to create consumer demand—once demand is created, intermediaries will feel obliged to carry the product.

In Japan, products often pass through two, three, or even four wholesalers before they reach the final retail outlet. This can make it difficult for foreign firms to break into the



MANAGEMENT FOCUS

Unilever—Selling to India's Poor

One of the world's largest and oldest consumer products companies, Unilever has long had a substantial presence in many of the world's poorer nations, such as India. Outside of major urban areas, low income, unsophisticated consumers, illiteracy, fragmented retail distribution systems, and the lack of paved roads have made for difficult marketing challenges. Despite this, Unilever has built a significant presence among impoverished rural populations by adopting innovative selling strategies.

India's large rural population is dispersed among some 600,000 villages, more than 500,000 of which cannot be reached by a motor vehicle. Some 91 percent of the rural population lives in villages of fewer than 2,000 people, and of necessity, rural retail stores are very small and carry limited stock. The population is desperately poor, making perhaps a dollar a day, and two-thirds of that income is spent on food, leaving about 30 cents a day for other items. Literacy levels are low, and TVs are rare, making traditional media ineffective. Despite these drawbacks, Hindustan Lever, Unilever's Indian subsidiary, has made a concerted effort to reach the rural poor. Although the revenues generated from rural sales are small, Unilever hopes that as the country develops and income levels rise, the population will continue to purchase the Unilever brands that they are familiar with, giving the company a long-term competitive advantage.

To contact rural consumers, Hindustan Lever tries to establish a physical presence wherever people frequently gather in numbers. This means ensuring that advertisements are seen in places where people congregate and make purchases, such as at village wells and weekly rural markets, and where they consume products, such as at riverbanks where people gather to wash their clothes using (the company hopes) Unilever soap. It is not uncommon to see the village well plastered with advertisements for Unilever products. The company also takes part in weekly rural events, such as market day, at which farm produce is sold and family provisions purchased. Hindustan Lever salesmen will visit these gatherings, display their products, explain how they work, give away some free samples, make a few sales, and seed the market for future demand.

The backbone of Hindustan Lever's selling effort, however, is a rural distribution network that encompasses 100 factories, 7,500 distributors, and an estimated 3 million retail stores, many of which are little more than a hole in a wall or a stall at a market. The total stock of Unilever products in these stores may be no more than a few sachets of shampoo and half a dozen bars of soap. A depot in each of India's states feeds products to major wholesalers, which then sell directly to retailers in thousands of small towns and villages that can be reached by motor vehicles. If access via motor vehicles is not possible, the major wholesalers sell to smaller second-tier wholesalers, which then handle distribution to India's 500,000 inaccessible rural villages, reaching them by bicycle, bullock, cart, or baskets carried on a human back.[18]

Japanese market. Not only must the foreign firm persuade a Japanese retailer to carry its product, but it may also have to persuade every intermediary in the chain to carry the product. Mass advertising may be one way to break down channel resistance in such circumstances. However, in countries such as India, which has a very long distribution channel to serve its massive rural population, mass advertising may not work because of low literacy levels, in which case the firm may need to fall back on direct selling or rely on the good will of distributors (see the Management Focus on Unilever).

Media Availability

A pull strategy relies on access to advertising media. In the United States, a large number of media are available, including print media (newspapers and magazines), broadcasting media (television and radio), and the Internet. The rise of cable television in the United States has facilitated extremely focused advertising (e.g., MTV for teens and young adults, Lifetime for women, ESPN for sports enthusiasts). The same is true of the Internet, with different websites attracting different kinds of users, and companies such

as Google transforming the ability of companies to do targeted advertising. While this level of media sophistication is now found in many other developed countries, it is still not universal. Even many advanced nations have far fewer electronic media available for advertising than the United States. In Scandinavia, for example, no commercial television or radio stations existed until recently; all electronic media were state owned and carried no commercials, although this has now changed with the advent of satellite television deregulation. In many developing nations, the situation is even more restrictive because mass media of all types are typically more limited. A firm's ability to use a pull strategy is limited in some countries by media availability. In such circumstances, a push strategy is more attractive. For example, Unilever uses a push strategy to sell consumer products in rural India, where few mass media are available (see the Management Focus).

Media availability is limited by law in some cases. Few countries allow advertisements for tobacco and alcohol products on television and radio, though they are usually permitted in print media. When the leading Japanese whiskey distiller, Suntory, entered the U.S. market, it had to do so without television, its preferred medium. The firm spends about $50 million annually on television advertising in Japan. Similarly, while advertising pharmaceutical products directly to consumers is allowed in the United States, it is prohibited in many other advanced nations. In such cases, pharmaceutical firms must rely heavily upon advertising and direct-sales efforts focused explicitly at doctors to get their products prescribed.

The Push-Pull Mix

The optimal mix between push and pull strategies depends on product type and consumer sophistication, channel length, and media sophistication. Push strategies tend to be emphasized

- For industrial products or complex new products.
- When distribution channels are short.
- When few print or electronic media are available.

Pull strategies tend to be emphasized

- For consumer goods.
- When distribution channels are long.
- When sufficient print and electronic media are available to carry the marketing message.

GLOBAL ADVERTISING

In recent years, largely inspired by the work of visionaries such as Theodore Levitt, there has been much discussion about the pros and cons of standardizing advertising worldwide.[19] One of the most successful standardized campaigns in history was Philip Morris's promotion of Marlboro cigarettes. The campaign was instituted in the 1950s, when the brand was repositioned, to assure smokers that the flavor would be unchanged by the addition of a filter. The campaign theme of "Come to where the flavor is: Come to Marlboro country" was a worldwide success. Marlboro built on this when it introduced "the Marlboro man," a rugged cowboy smoking his Marlboro while riding his horse through the great outdoors. This ad proved successful in almost every major market around the world, and it helped propel Marlboro to the top of the world market.

For Standardized Advertising

The support for global advertising is threefold. First, it has significant economic advantages. Standardized advertising lowers the costs of value creation by spreading the fixed



MANAGEMENT FOCUS

Dove's Global "Real Beauty" Campaign

In 2003, Dove was not a beauty brand; it was a bar of soap that was positioned and sold differently in different markets. Unilever, the company that marketed Dove, was a storied consumer product multinational with global reach, a strong position in fast-growing developing nations, and a reputation for customizing products to conditions prevailing in local markets. In India, for example, woman often oil their hair before washing it, so Western shampoos that do not remove the oil have not sold well. Unilever reformulated its shampoo for India and was rewarded with market leadership. But sometimes Unilever went too far. It used different formulations for shampoo in Hong Kong and mainland China for example, even though hair and washing habits were very similar in both markets. Unilever would also often vary the packaging and marketing message in similar products, even for its most commoditized products. The company tended to exaggerate complexity, and by 2003 its financial performance was suffering.

Seven years later Unilever's financial performance has improved, in no small part because it has shifted toward a more global emphasis, and the Dove brand has led the way. The Dove story dates to 2003 when the global brand director, Sylvia Lagnado, who was based in New York, decided to move the positioning of Dove from one based on the product to one of an entire beauty brand. The basic message: The brand should stand for the real beauty of all women. Dove's mission was to make women feel more beautiful every day by widening the stereotypical definition of beauty and inspiring them to take care of themselves.

But how was this mission to be executed? Following a series of workshops held around the globe that asked brand managers and advertising agency partners to find ways to communicate an inclusive definition of beauty, the Canadian brand manager asked 67 female photographers to submit work that best reflects real beauty. The photographs are stunning portraits not of models, but of women from all walks of life that come in all shapes, sizes, and ages. It led to a coffee table book and traveling exhibition, called the Dove Photo Tour, which garnered a lot of positive press in Canada. Sylvia Lagnado realized that the Canadians were on to something. Around the same time, the German office of Unilever's advertising agency, Ogilvy and Mather Worldwide, came up with a concept for communicating "real beauty" based on photographs showing, instead of skinny models, ordinary women in their underwear. The original German advertisements quickly made their way to the United Kingdom, where a London newspaper article stated the campaign was not advertising; it was politics. Lagnado was not surprised by this. She had commissioned research that revealed only 2 percent of women worldwide considered themselves beautiful, and that half thought their weight was too high.

In 2004, the "Dove Campaign for Real Beauty" was launched globally. This was a radical shift for Unilever and the Dove brand, which until then had left marketing in the hands of local brand managers. The Real Beauty campaign was tweaked to take local sensibilities into account. For example, it was deemed better not to show women touching each other in America, while in Latin America tactile women do not shock anybody, so touching was seen as OK.

In Canada, the campaign opened with billboard "tick box" advertisements on real women in their underwear that invited people to call a toll-free number and vote on provocative tickers, such as "Fat/Fabulous?" The votes were tallied and displayed in real time on the billboards. This created a huge buzz, and the technique was quickly adopted in other markets, including the United States. As the campaign gained traction and a positive groundswell of media attention occurred (in the United States, for example, the Dove Women were invited to Oprah Winfrey's TV talk show). Unilever soon extended the Dove product line to include skin creams, shampoos, and shower gels. In 2005, the campaign was followed by the launch of the Dove "self-esteem fund," a worldwide campaign to persuade girls and young women to embrace a more positive image of themselves. Unilever also made an online video, loaded onto YouTube, called "Onslaught," which was critical of the beauty industry and ended with the slogan "Talk to your daughter before the beauty industry does." Another video, "Evolution," showed how the face of a girl can be changed, partly through computer graphics, to create an image of beauty. The video ended with the tag line "No wonder our perception of beauty is distorted." Made for very little money, the YouTube videos created a viral buzz around the campaign that helped to transform Dove into one of Unilever's leading brands. By its use of such techniques, the campaign has become a model for how to revitalize and build a new global brand.[20]

costs of developing the advertisements over many countries. For example, Coca-Cola's advertising agency, McCann-Erickson, claims to have saved Coca-Cola $90 million over 20 years by using certain elements of its campaigns globally.

Second, there is the concern that creative talent is scarce and so one large effort to develop a campaign will produce better results than 40 or 50 smaller efforts. A third justification for a standardized approach is that many brand names are global. With the substantial amount of international travel today and the considerable overlap in media across national borders, many international firms want to project a single brand image to avoid confusion caused by local campaigns. This is particularly important in regions such as Western Europe, where travel across borders is almost as common as travel across state lines in the United States.

Against Standardized Advertising

There are two main arguments against globally standardized advertising. First, as we have seen repeatedly in this chapter and in Chapter 3, cultural differences between nations are such that a message that works in one nation can fail miserably in another. Cultural diversity makes it extremely difficult to develop a single advertising theme that is effective worldwide. Messages directed at the culture of a given country may be more effective than global messages.

Second, advertising regulations may block implementation of standardized advertising. For example, Kellogg could not use a television commercial it produced in Great Britain to promote its cornflakes in many other European countries. A reference to the iron and vitamin content of its cornflakes was not permissible in the Netherlands, where claims relating to health and medical benefits are outlawed. A child wearing a Kellogg T-shirt had to be edited out of the commercial before it could be used in France, because French law forbids the use of children in product endorsements. The key line "Kellogg's makes their cornflakes the best they have ever been" was disallowed in Germany because of a prohibition against competitive claims.[21] Similarly, American Express ran afoul of regulatory authorities in Germany when it launched a promotional scheme that had proved successful in other countries. The scheme advertised the offer of "bonus points" every time American Express cardholders used their cards. According to the advertisements, these bonus points could be used toward air travel with three airlines and hotel accommodations. American Express was charged with breaking Germany's competition law, which prevents an offer of free gifts in connection with the sale of goods, and the firm had to withdraw the advertisements at considerable cost.[22]

Dealing with Country Differences

Some firms are experimenting with capturing some benefits of global standardization while recognizing differences in countries' cultural and legal environments. A firm may select some features to include in all its advertising campaigns and localize other features. By doing so, it may be able to save on some costs and build international brand recognition and yet customize its advertisements to different cultures.

Nokia, the Finnish cell phone manufacturer, has been trying to do this. Historically, Nokia had used a different advertising campaign in different markets. In the mid-2000s, however, the company launched a global advertising campaign that used the slogan "1001 reasons to have a Nokia imaging phone." Nokia did this to reduce advertising costs and capture some economies of scale. In addition, in an increasingly integrated world the company believes there is value in trying to establish a consistent global brand image. At the same time, Nokia is tweaking the advertisements for different cultures. The campaign uses actors from the region where the ad runs to reflect the local population, though they say the same lines. Local settings are also modified when showcasing the phones by, for example, using a marketplace when advertising in Italy or a bazaar when advertising in the Middle East.[23] Another example of this process is given

in the accompanying Management Focus, which looks at how Unilever built a global brand for its Dove products, while still tweaking the message to consider local sensibilities.

Pricing Strategy

International pricing strategy is an important component of the overall international marketing mix.[24] This section looks at three aspects of international pricing strategy. First, we examine the case for pursuing price discrimination, charging different prices for the same product in different countries. Second, we look at what might be called strategic pricing. Third, we review regulatory factors, such as government-mandated price controls and antidumping regulations, that limit a firm's ability to charge the prices it would prefer in a country.

PRICE DISCRIMINATION

Price discrimination exists whenever consumers in different countries are charged different prices for the same product, or for slightly different variations of the product.[25] Price discrimination involves charging whatever the market will bear; in a competitive market, prices may have to be lower than in a market where the firm has a monopoly. Price discrimination can help a company maximize its profits. It makes economic sense to charge different prices in different countries.

Two conditions are necessary for profitable price discrimination. First, the firm must be able to keep its national markets separate. If it cannot do this, individuals or businesses may undercut its attempt at price discrimination by engaging in arbitrage. Arbitrage occurs when an individual or business capitalizes on a price differential for a firm's product between two countries by purchasing the product in the country where prices are lower and reselling it in the country where prices are higher. For example, many automobile firms have long practiced price discrimination in Europe. A Ford Escort once cost $2,000 more in Germany than it did in Belgium. This policy broke down when car dealers bought Escorts in Belgium and drove them to Germany, where they sold them at a profit for slightly less than Ford was selling Escorts in Germany. To protect the market share of its German auto dealers, Ford had to bring its German prices into line with those being charged in Belgium. Ford could not keep these markets separate.

However, Ford still practices price discrimination between Great Britain and Belgium. A Ford car can cost up to $3,000 more in Great Britain than in Belgium. In this case, arbitrage has not been able to equalize the price, because right-hand-drive cars are sold in Great Britain and left-hand-drive cars in the rest of Europe. Because there is no market for left-hand-drive cars in Great Britain, Ford has been able to keep the markets separate.

The second necessary condition for profitable price discrimination is different price elasticities of demand in different countries. The **price elasticity of demand** is a measure of the responsiveness of demand for a product to change in price. Demand is said to be **elastic** when a small change in price produces a large change in demand; it is said to be **inelastic** when a large change in price produces only a small change in demand. Figure 18.2 illustrates elastic and inelastic demand curves. Generally, a firm can charge a higher price in a country where demand is inelastic.

The elasticity of demand for a product in a given country is determined by a number of factors, of which income level and competitive conditions are the two most important. Price elasticity tends to be greater in countries with low income levels. Consumers with limited incomes tend to be very price conscious; they have less to spend, so they look much more closely at price. Thus, price elasticity for products such as personal computers is greater in countries such as India, where a PC is still a luxury item, than in the United States, where it is now considered a necessity. The same is true of the software

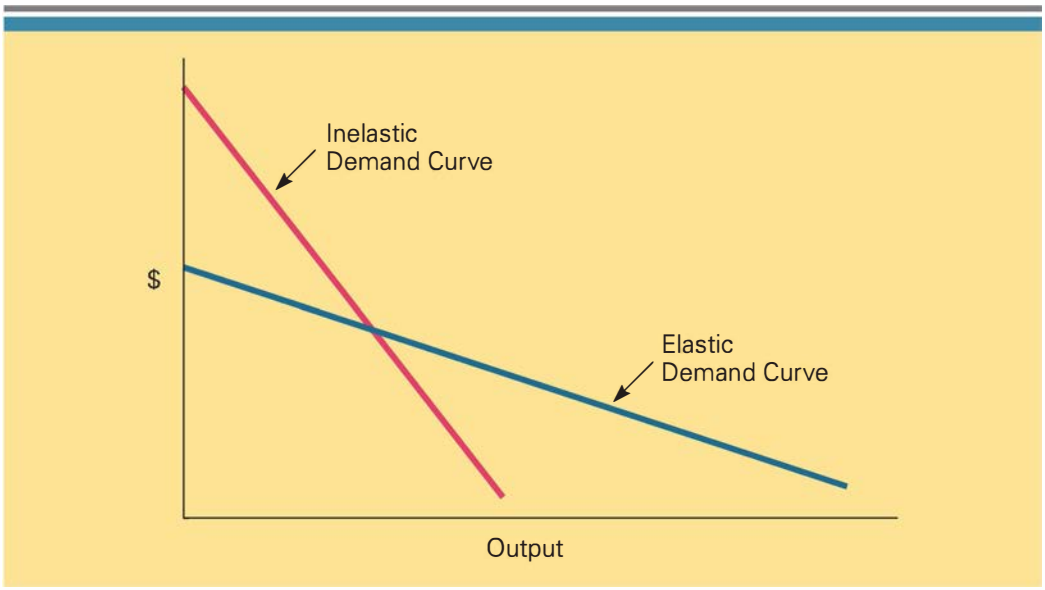


FIGURE 18.2
Elastic and Inelastic Demand Curves

that resides on those PCs; thus, to sell more software in India, Microsoft has had to introduce low-priced versions of its products into that market, such as Windows Starter Edition.

In general, the more competitors there are, the greater consumers' bargaining power will be and the more likely consumers will be to buy from the firm that charges the lowest price. Thus, many competitors cause high elasticity of demand. In such circumstances, if a firm raises its prices above those of its competitors, consumers will switch to the competitors' products. The opposite is true when a firm faces few competitors. When competitors are limited, consumers' bargaining power is weaker and price is less important as a competitive weapon. Thus, a firm may charge a higher price for its product in a country where competition is limited than in one where competition is intense.

STRATEGIC PRICING

The concept of **strategic pricing** has three aspects, which we will refer to as predatory pricing, multipoint pricing, and experience curve pricing. Both predatory pricing and experience curve pricing may violate antidumping regulations. After we review predatory and experience curve pricing, we will look at antidumping rules and other regulatory policies.

Predatory Pricing

Predatory pricing is the use of price as a competitive weapon to drive weaker competitors out of a national market. Once the competitors have left the market, the firm can raise prices and enjoy high profits. For such a pricing strategy to work, the firm must normally have a profitable position in another national market, which it can use to subsidize aggressive pricing in the market it is trying to monopolize. Historically, many Japanese firms were accused of pursuing such a policy. The argument ran like this: Because the Japanese market was protected from foreign competition by high informal trade barriers, Japanese firms could charge high prices and earn high profits at home. They then used these profits to subsidize aggressive pricing overseas, with the goal of driving competitors out of those markets. Once this had occurred, so it is claimed, the Japanese firms then raised prices. Matsushita was accused of using this strategy to enter the U.S. TV market. As one of the major TV producers in Japan, Matsushita earned high profits at home. It then used these profits to subsidize the losses

it made in the United States during its early years there, when it priced low to increase its market penetration. Ultimately, Matsushita became the world's largest manufacturer of TVs.[26]

Multipoint Pricing Strategy

Multipoint pricing becomes an issue when two or more international businesses compete against each other in two or more national markets. For example, multipoint pricing was an issue for Kodak and Fuji Photo because the companies long competed against each other around the world in the market for silver halide film.[27] **Multipoint pricing** refers to the fact a firm's pricing strategy in one market may have an impact on its rivals' pricing strategy in another market. Aggressive pricing in one market may elicit a competitive response from a rival in another market. For example, Fuji launched an aggressive competitive attack against Kodak in the U.S. company's home market in January 1997, cutting prices on multiple-roll packs of 35mm film by as much as 50 percent.[28] This price cutting resulted in a 28 percent increase in shipments of Fuji color film during the first six months of 1997, while Kodak's shipments dropped by 11 percent. This attack created a dilemma for Kodak; the company did not want to start price discounting in its largest and most profitable market. Kodak's response was to aggressively cut prices in Fuji's largest market, Japan. This strategic response recognized the interdependence between Kodak and Fuji and the fact that they compete against each other in many different nations. Fuji responded to Kodak's counterattack by pulling back from its aggressive stance in the United States.

The Kodak story illustrates an important aspect of multipoint pricing: Aggressive pricing in one market may elicit a response from rivals in another market. The firm needs to consider how its global rivals will respond to changes in its pricing strategy before making those changes. A second aspect of multipoint pricing arises when two or more global companies focus on particular national markets and launch vigorous price wars in those markets in an attempt to gain market dominance. In the Brazil market for disposable diapers, two U.S. companies, Kimberly-Clark Corp. and Procter & Gamble, entered a price war as each struggled to establish dominance in the market.[29] As a result, over three years the cost of disposable diapers fell from $1 per diaper to 33 cents per diaper, while several other competitors, including indigenous Brazilian firms, were driven out of the market. Kimberly-Clark and Procter & Gamble are engaged in a global struggle for market share and dominance, and Brazil is one of their battlegrounds. Both companies can afford to engage in this behavior, even though it reduces their profits in Brazil, because they have profitable operations elsewhere in the world that can subsidize these losses.

Pricing decisions around the world need to be centrally monitored. It is tempting to delegate full responsibility for pricing decisions to the managers of various national subsidiaries, thereby reaping the benefits of decentralization. However, because pricing strategy in one part of the world can elicit a competitive response in another, central management needs to at least monitor and approve pricing decisions in a given national market, and local managers need to recognize that their actions can affect competitive conditions in other countries.

Experience Curve Pricing

We first encountered the experience curve in Chapter 13. As a firm builds its accumulated production volume over time, unit costs fall due to experience effects. Learning effects and economies of scale underlie the experience curve. Price comes into the picture because aggressive pricing (along with aggressive promotion and advertising) can build accumulated sales volume rapidly and thus move production down the experience curve. Firms further down the experience curve have a cost advantage vis-à-vis those further up the curve.

Many firms pursuing an **experience curve pricing** strategy on an international scale will price low worldwide in attempting to build global sales volume as rapidly as possible,

even if this means taking large losses initially. Such a firm believes that in several years, when it has moved down the experience curve, it will be making substantial profits and have a cost advantage over its less-aggressive competitors.

REGULATORY INFLUENCES ON PRICES

The ability to engage in either price discrimination or strategic pricing may be limited by national or international regulations. Most important, a firm's freedom to set its own prices is constrained by antidumping regulations and competition policy.

Antidumping Regulations

Both predatory pricing and experience curve pricing can run afoul of antidumping regulations. Dumping occurs whenever a firm sells a product for a price that is less than the cost of producing it. Most regulations, however, define dumping more vaguely. For example, a country is allowed to bring antidumping actions against an importer under Article 6 of GATT as long as two criteria are met: sales at "less than fair value" and "material injury to a domestic industry." The problem with this terminology is that it does not indicate what a fair value is. The ambiguity has led some to argue that selling abroad at prices below those in the country of origin, as opposed to below cost, is dumping.

Such logic led the Bush administration to place a 20 percent duty on imports of foreign steel in 2001. Foreign manufacturers protested that they were not selling below cost. Admitting that their prices were lower in the United States than some other countries, they argued that this simply reflected the intensely competitive nature of the U.S. market (i.e., different price elasticities).

Antidumping rules set a floor under export prices and limit firms' ability to pursue strategic pricing. The rather vague terminology used in most antidumping actions suggests that a firm's ability to engage in price discrimination also may be challenged under antidumping legislation.

Competition Policy

Most developed nations have regulations designed to promote competition and to restrict monopoly practices. These regulations can be used to limit the prices a firm can charge in a given country. For example, at one time the Swiss pharmaceutical manufacturer Hoffmann-LaRoche had a monopoly on the supply of Valium and Librium tranquilizers. The company was investigated by the British Monopolies and Mergers Commission, which is responsible for promoting fair competition in Great Britain. The commission found that Hoffmann-LaRoche was overcharging for its tranquilizers and ordered the company to reduce its prices 35 to 40 percent. Hoffmann-LaRoche maintained unsuccessfully that it was merely engaging in price discrimination. Similar actions were later brought against Hoffmann-LaRoche by the German cartel office and by the Dutch and Danish governments.[30]

Configuring the Marketing Mix

A firm might vary aspects of its marketing mix from country to country to take into account local differences in culture, economic conditions, competitive conditions, product and technical standards, distribution systems, government regulations, and the like. Such differences may require variation in product attributes, distribution strategy, communications strategy, and pricing strategy. The cumulative effect of these factors makes it rare for a firm to adopt the same marketing mix worldwide. A detailed example is given in the accompanying Management Focus, which looks at how Levi Strauss now varies its marketing mix from country to country. This is a particularly interesting example because Theodore Levitt held up Levi Strauss as an example of global



MANAGEMENT FOCUS

Levi Strauss Goes Local

It's been a tough few years for Levi Strauss, the iconic manufacturer of blue jeans. The company, whose 501 jeans became the global symbol of the baby boom generation and were sold in more than 100 countries, saw its sales drop from a peak of $7.1 billion in 1996 to just $4.0 billion in 2004. Fashion trends had moved on, its critics charged, and Levi Strauss, hamstrung by high costs and a stagnant product line, was looking more faded than a well-worn pair of 501s. Perhaps so, but 2005–2010 brought signs that a turnaround was in progress. Sales increased for the first time in eight years, and after a string of losses the company started to register profits again.

There were three parts to this turnaround. First, there were cost reductions at home. Levi Strauss closed its last remaining American factories and moved production offshore where jeans could be produced more cheaply. Second, the company broadened its product line, introducing the Levi's Signature brand that could be sold through lower-priced outlets in markets that were more competitive, including the core American market where Walmart had driven down prices. Third, there was a decision in the late 1990s to give more responsibility to national managers, allowing them to better tailor the product offering and marketing mix to local conditions. Before this, Levi Strauss had basically sold the same product worldwide, often using the same advertising message. The old strategy was designed to enable the company to realize economies of scale in production and advertising, but it wasn't working.

Under the new strategy, variations between national markets have become more pronounced. Jeans have been tailored to different body types. In Asia, shorter leg lengths are common, whereas in South Africa, more room is needed for the backside of women's jeans, so Levi Strauss has customized the product offering to account for these physical differences. Then there are sociocultural differences: In Japan, tight-fitting black jeans are popular; in Islamic countries, women are discouraged from wearing tight-fitting jeans, so Levi Strauss offerings in countries such as Turkey are roomier. Climate also has an effect on product design. In northern Europe, standard-weight jeans are sold, whereas in hotter countries lighter denim is used, along with brighter colors that are not washed out by the tropical sun.

Levi's ads, which used to be global, have also been tailored to regional differences. In Europe, the ads now talk about the cool fit. In Asia, they talk about the rebirth of an original. In the United States, the ads show real people who are themselves originals: ranchers, surfers, great musicians. There are also differences in distribution channels and pricing strategy. In the fiercely competitive American market, prices are as low as $25 and Levi's are sold through mass-market discount retailers, such as Walmart. In India, strong sales growth is being driven by Levi's low-priced Signature brand. In Spain, jeans are seen as higher fashion items and are being sold for $50 in higher-quality outlets. In the United Kingdom too, prices for 501s are much higher than in the United States, reflecting a more benign competitive environment.

This variation in marketing mix seems to be reaping dividends; although demand in the United States and Europe remains sluggish, growth in many other countries is strong. Turkey, South Korea, and South Africa all recorded growth rates in excess of 20 percent a year following the introduction of this strategy in 2005. Looking forward, Levi Strauss expects 60 percent of its growth to come from emerging markets.[31]

standardization, but as the Management Focus makes clear, the opposite now seems to be the case.

The financial services industry is often thought of as one in which global standardization of the marketing mix is the norm. However, while a financial services company such as American Express may sell the same basic charge card service worldwide, utilize the same basic fee structure for that product, and adopt the same basic global advertising message ("don't leave home without it"), differences in national regulations still mean that it has to vary aspects of its communications strategy from country to country (as

pointed out earlier, the promotional strategy it had developed in the United States was illegal in Germany). Similarly, while McDonald's is often thought of as the quintessential example of a firm that sells the same basic standardized product worldwide, in reality it varies one important aspect of its marketing mix—its menu—from country to country. McDonald's also varies its distribution strategy. In Canada and the United States, most McDonald's are located in areas that are easily accessible by car, whereas in more densely populated and less automobile-reliant societies of the world, such as Japan and Great Britain, location decisions are driven by the accessibility of a restaurant to pedestrian traffic. Because countries typically still differ along one or more of the dimensions discussed above, some customization of the marketing mix is normal.

However, there are often significant opportunities for standardization along one or more elements of the marketing mix.[32] Firms may find that it is possible and desirable to standardize their global advertising message or core product attributes to realize substantial cost economies. They may find it desirable to customize their distribution and pricing strategy to take advantage of local differences. In reality, the "customization versus standardization" debate is not an all or nothing issue; it frequently makes sense to standardize some aspects of the marketing mix and customize others, depending on conditions in various national marketplaces.

New-Product Development

Firms that successfully develop and market new products can earn enormous returns. Examples include Du Pont, which has produced a steady stream of successful innovations such as cellophane, nylon, Freon, and Teflon (nonstick pans); Sony, whose successes include the Walkman, the compact disk, the PlayStation, the Blu-ray high-definition DVD player; Pfizer, the drug company that during the 1990s produced several major new drugs, including Viagra; 3M, which has applied its core competency in tapes and adhesives to developing a wide range of new products; Intel, which has consistently managed to lead in the development of innovative microprocessors to run personal computers; and Cisco Systems, which developed the routers that sit at the hubs of Internet connections, directing the flow of digital traffic.

In today's world, competition is as much about technological innovation as anything else. The pace of technological change has accelerated since the Industrial Revolution in the eighteenth century, and it continues to do so today. The result has been a dramatic shortening of product life cycles. Technological innovation is both creative and destructive.[33] An innovation can make established products obsolete overnight. But an innovation can also make a host of new products possible. Witness recent changes in the electronics industry. For 40 years before the early 1950s, vacuum tubes were a major component in radios and then in record players and early computers. The advent of transistors destroyed the market for vacuum tubes, but at the same time it created new opportunities connected with transistors. Transistors took up far less space than vacuum tubes, creating a trend toward miniaturization that continues today. The transistor held its position as the major component in the electronics industry for just a decade. Microprocessors were developed in the 1970s, and the market for transistors declined rapidly. The microprocessor created yet another set of new-product opportunities: handheld calculators (which destroyed the market for slide rules), compact disk players (which destroyed the market for analog record players), personal computers (which destroyed the market for typewriters), cell phones (which may ultimately replace landline phones), to name a few.

This "creative destruction" unleashed by technological change makes it critical that a firm stay on the leading edge of technology, lest it lose out to a competitor's innovations. As explained in the next subsection, this not only creates a need for the firm to invest in R&D, but it also requires the firm to establish R&D activities at those locations where expertise is concentrated. As we shall see, leading-edge

technology on its own is not enough to guarantee a firm's survival. The firm must also apply that technology to developing products that satisfy consumer needs, and it must design the product so that it can be manufactured in a cost-effective manner. To do that, the firm needs to build close links between R&D, marketing, and manufacturing. This is difficult enough for the domestic firm, but it is even more problematic for the international business competing in an industry where consumer tastes and preferences differ from country to country.[34] With all of this in mind, we move on to examine locating R&D activities and building links between R&D, marketing, and manufacturing.

THE LOCATION OF R&D

Ideas for new products are stimulated by the interactions of scientific research, demand conditions, and competitive conditions. Other things being equal, the rate of new-product development seems to be greater in countries where

- More money is spent on basic and applied research and development.
- Underlying demand is strong.
- Consumers are affluent.
- Competition is intense.[35]

Basic and applied research and development discovers new technologies and then commercializes them. Strong demand and affluent consumers create a potential market for new products. Intense competition between firms stimulates innovation as the firms try to beat their competitors and reap potentially enormous first-mover advantages that result from successful innovation.

For most of the post-World War II period, the country that ranked highest on these criteria was the United States. The United States devoted a greater proportion of its gross domestic product to R&D than any other country did. Its scientific establishment was the largest and most active in the world. U.S. consumers were the most affluent, the market was large, and competition among U.S. firms was brisk. Due to these factors, the United States was the market where most new products were developed and introduced. Accordingly, it was the best location for R&D activities; it was where the action was.

Over the past 20 years, things have been changing quickly. The U.S. monopoly on new-product development has weakened considerably. Although U.S. firms are still at the leading edge of many new technologies, Asian and European firms are also strong players, with companies such as Sony, Sharp, Samsung, Ericsson, Nokia, and Philips driving product innovation in their respective industries. In addition, both Japan and the European Union are large, affluent markets, and the wealth gap between them and the United States is closing.

As a result, it is often no longer appropriate to consider the United States as the lead market. In video games, for example, Japan is often the lead market, with companies such as Sony and Nintendo introducing their latest video game players in Japan some six months before they introduce them in the United States. In wireless telecommunications, Europe is generally reckoned to be ahead of the United States. Some of the most advanced applications of wireless telecommunications services are being pioneered not in the United States but in Finland, where more than 90 percent of the population has wireless telephones, compared with 65 percent of the U.S. population. However, it often is questionable whether any developed nation can be considered the lead market. To succeed in today's high-technology industries, it is often necessary to simultaneously introduce new products in all major industrialized markets. When Intel introduces a new microprocessor, for example, it does not first introduce it in the United States and then roll it out in Europe a year later. It introduces it simultaneously around the world.

Because leading-edge research is now carried out in many locations around the world, the argument for centralizing R&D activity in the United States is now much

weaker than it was two decades ago. (It used to be argued that centralized R&D eliminated duplication.) Much leading-edge research is now occurring in Japan and Europe. Dispersing R&D activities to those locations allows a firm to stay close to the center of leading-edge activity to gather scientific and competitive information and to draw on local scientific resources.[36] This may result in some duplication of R&D activities, but the cost disadvantages of duplication are outweighed by the advantages of dispersion.

For example, to expose themselves to the research and new-product development work being done in Japan, many U.S. firms have set up satellite R&D centers in Japan. Kodak's R&D center in Japan employs about 200 people. The company hired about 100 Japanese researchers and directed the lab to concentrate on electronic imaging technology. U.S. firms that have established R&D facilities in Japan include Corning, Texas Instruments, IBM, Digital Equipment, Procter & Gamble, Upjohn, Pfizer, Du Pont, Monsanto, and Microsoft.[37] The National Science Foundation (NSF) has documented a sharp increase in the proportion of total R&D spending by U.S. firms that is now done abroad.[38] For example, Motorola now has 14 dedicated R&D facilities located in seven countries, and Bristol-Myers Squibb has 12 facilities in six countries. At the same time, to internationalize their own research and gain access to U.S. talent, many European and Japanese firms are investing in U.S.-based research facilities, according to the NSF.

INTEGRATING R&D, MARKETING, AND PRODUCTION

Although a firm that is successful at developing new products may earn enormous returns, new-product development has a high failure rate. One study of product development in 16 companies in the chemical, drug, petroleum, and electronics industries suggested that only about 20 percent of R&D projects result in commercially successful products or processes.[39] Another in-depth case study of product development in three companies (one in chemicals and two in drugs) reported that about 60 percent of R&D projects reached technical completion, 30 percent were commercialized, and only 12 percent earned an economic profit that exceeded the company's cost of capital.[40] Along the same lines, another study concluded that one in nine major R&D projects, or about 11 percent, produced commercially successful products.[41] In sum, the evidence suggests that only 10 to 20 percent of major R&D projects give rise to commercially successful products. Well-publicized product failures include Apple Computer's Newton personal digital assistant, Sony's Betamax format in the video player and recorder market, and Sega's Dreamcast video game console.

The reasons for such high failure rates are various and include development of a technology for which demand is limited, failure to adequately commercialize promising technology, and inability to manufacture a new product cost effectively. Firms can reduce the probability of making such mistakes by insisting on tight cross-functional coordination and integration between three core functions involved in the development of new products: R&D, marketing, and production.[42] Tight cross-functional integration between R&D, production, and marketing can help a company to ensure that

1. Product development projects are driven by customer needs.
2. New products are designed for ease of manufacture.
3. Development costs are kept in check.
4. Time to market is minimized.

Close integration between R&D and marketing is required to ensure that product development projects are driven by the needs of customers. A company's customers can be a primary source of new-product ideas. Identification of customer needs, particularly unmet needs, can set the context within which successful product innovation occurs. As the point of contact with customers, the marketing function of a company can

provide valuable information in this regard. Integration of R&D and marketing is crucial if a new product is to be properly commercialized. Without integration of R&D and marketing, a company runs the risk of developing products for which there is little or no demand.

Integration between R&D and production can help a company design products with manufacturing requirements in mind. Designing for manufacturing can lower costs and increase product quality. Integrating R&D and production can also help lower development costs and speed products to market. If a new product is not designed with manufacturing capabilities in mind, it may prove too difficult to build. Then the product will have to be redesigned, and both overall development costs and the time it takes to bring the product to market may increase significantly. Making design changes during product planning could increase overall development costs by 50 percent and add 25 percent to the time it takes to bring the product to market.[43] Many quantum product innovations require new processes to manufacture them, which makes it all the more important to achieve close integration between R&D and production. Minimizing time to market and development costs may require the simultaneous development of new products and new processes.[44]

CROSS-FUNCTIONAL TEAMS

One way to achieve cross-functional integration is to establish cross-functional product development teams composed of representatives from R&D, marketing, and production. Because these functions may be located in different countries, the team will sometimes have a multinational membership. The objective of a team should be to take a product development project from the initial concept development to market introduction. A number of attributes seem to be important for a product development team to function effectively and meet all its development milestones.[45]

First, the team should be led by a "heavyweight" project manager who has high status within the organization and who has the power and authority required to get the financial and human resources the team needs to succeed. The leader should be dedicated primarily, if not entirely, to the project. He or she should be someone who believes in the project (a champion) and who is skilled at integrating the perspectives of different functions and at helping personnel from different functions and countries work together for a common goal. The leader should also be able to act as an advocate of the team to senior management.

Second, the team should be composed of at least one member from each key function. The team members should have a number of attributes, including an ability to contribute functional expertise, high standing within their function, a willingness to share responsibility for team results, and an ability to put functional and national advocacy aside. It is generally preferable if core team members are 100 percent dedicated to the project for its duration. This assures their focus on the project, not on the ongoing work of their function.

Third, the team members should physically be in one location if possible to create a sense of camaraderie and to facilitate communication. This presents problems if the team members are drawn from facilities in different nations. One solution is to transfer key individuals to one location for the duration of a product development project. Fourth, the team should have a clear plan and clear goals, particularly with regard to critical development milestones and development budgets. The team should have incentives to attain those goals, such as receiving pay bonuses when major development milestones are hit. Fifth, each team needs to develop its own processes for communication and conflict resolution. For example, one product development team at Quantum Corporation, a California-based manufacturer of disk drives for personal computers, instituted a rule that all major decisions would be made and conflicts resolved at meetings that were held every Monday afternoon. This simple rule helped the team meet its development goals. In this case, it was also common for team members to fly in from Japan,

where the product was to be manufactured, to the U.S. development center for the Monday morning meetings.[46]

BUILDING GLOBAL R&D CAPABILITIES

The need to integrate R&D and marketing to adequately commercialize new technologies poses special problems in the international business because commercialization may require different versions of a new product to be produced for various countries.[47] To do this, the firm must build close links between its R&D centers and its various country operations. A similar argument applies to the need to integrate R&D and production, particularly in those international businesses that have dispersed production activities to different locations around the globe in consideration of relative factor costs and the like.

Integrating R&D, marketing, and production in an international business may require R&D centers in North America, Asia, and Europe that are linked by formal and informal integrating mechanisms with marketing operations in each country in their regions and with the various manufacturing facilities. In addition, the international business may have to establish cross-functional teams whose members are dispersed around the globe. This complex endeavor requires the company to utilize formal and informal integrating mechanisms to knit its far-flung operations together so they can produce new products in an effective and timely manner.

While there is no one best model for allocating product development responsibilities to various centers, one solution adopted by many international businesses involves establishing a global network of R&D centers. Within this model, fundamental research is undertaken at basic research centers around the globe. These centers are normally located in regions or cities where valuable scientific knowledge is being created and where there is a pool of skilled research talent (e.g., Silicon Valley in the United States, Cambridge in England, Kobe in Japan, Singapore). These centers are the innovation engines of the firm. Their job is to develop the basic technologies that become new products.

These technologies are picked up by R&D units attached to global product divisions and are used to generate new products to serve the global marketplace. At this level, commercialization of the technology and design for manufacturing are emphasized. If further customization is needed so the product appeals to the tastes and preferences of consumers in individual markets, such redesign work will be done by an R&D group based in a subsidiary in that country or at a regional center that customizes products for several countries in the region.

Hewlett-Packard has four basic research centers located in Palo Alto, California; Bristol, England; Haifa, Israel; and Tokyo, Japan.[48] These labs are the seedbed for technologies that ultimately become new products and businesses. They are the company's innovation engines. The Palo Alto center, for example, pioneered HP's thermal ink-jet technology. The products are developed by R&D centers associated with HP's global product divisions. Thus, the Consumer Products Group, which has its worldwide headquarters in San Diego, California, designs, develops, and manufactures a range of imaging products using HP-pioneered thermal ink-jet technology. Subsidiaries might then customize the product so that it best matches the needs of important national markets. HP's subsidiary in Singapore, for example, is responsible for the design and production of thermal ink-jet printers for Japan and other Asian markets. This subsidiary takes products originally developed in San Diego and redesigns them for the Asian market. In addition, the Singapore subsidiary has taken the lead from San Diego in the design and development of certain portable thermal ink-jet printers. HP delegated this responsibility to Singapore because this subsidiary has acquired important competencies in the design and production of thermal ink-jet products, so it has become the best place in the world to undertake this activity.

Microsoft offers a similar example. The company has basic research sites in Redmond, Washington (its headquarters); Silicon Valley, California, Cambridge, England; Tokyo, Japan; Beijing, China; and Bangalore, India. Staff at these research sites work on the fundamental problems that underlie the design of future products. For example, a group at Redmond is working on natural language recognition software, while another works on artificial intelligence. These research centers don't produce new products; rather, they produce the technology that is used to enhance existing products or help produce new products. The products are produced by dedicated product groups (e.g., desktop operating systems, applications). Customization of the products to match the needs of local markets is sometimes carried out at local subsidiaries. Thus, the Chinese subsidiary will do some basic customization of programs such as Microsoft Office, adding Chinese characters and customizing the interface, and as we see in the closing case, the R&D group in India has helped to develop products for that market.

CHAPTER SUMMARY

This chapter discussed the marketing and R&D functions in international business. A persistent theme of the chapter is the tension that exists between the need to reduce costs and the need to be responsive to local conditions, which raises costs. The chapter made the following points:

1. Theodore Levitt argued that due to the advent of modern communications and transport technologies, consumer tastes and preferences are becoming global, which is creating global markets for standardized consumer products. However, this position is regarded as extreme by many commentators, who argue that substantial differences still exist between countries.
2. Market segmentation refers to the process of identifying distinct groups of consumers whose purchasing behavior differs from each other in important ways. Managers in an international business need to be aware of two main issues relating to segmentation: the extent to which there are differences between countries in the structure of market segments, and the existence of segments that transcend national borders.
3. A product can be viewed as a bundle of attributes. Product attributes need to be varied from country to country to satisfy different consumer tastes and preferences.
4. Country differences in consumer tastes and preferences are due to differences in culture and economic development. In addition, differences in product and technical standards may require the firm to customize product attributes from country to country.
5. A distribution strategy decision is an attempt to define the optimal channel for delivering a product to the consumer.
6. Significant country differences exist in distribution systems. In some countries, the retail system is concentrated; in others, it is fragmented. In some countries, channel length is short; in others, it is long. Access to distribution channels is difficult to achieve in some countries, and the quality of the channel may be poor.
7. A critical element in the marketing mix is communication strategy, which defines the process the firm will use in communicating the attributes of its product to prospective customers.
8. Barriers to international communication include cultural differences, source effects, and noise levels.
9. A communication strategy is either a push strategy or a pull strategy. A push strategy emphasizes personal selling, and a pull strategy emphasizes mass media advertising. Whether a push strategy or a pull strategy is optimal depends on the type of product, consumer sophistication, channel length, and media availability.
10. A globally standardized advertising campaign, which uses the same marketing message all over the world, has economic advantages, but it fails

to account for differences in culture and advertising regulations.

11. Price discrimination exists when consumers in different countries are charged different prices for the same product. Price discrimination can help a firm maximize its profits. For price discrimination to be effective, the national markets must be separate and their price elasticities of demand must differ.
12. Predatory pricing is the use of profit gained in one market to support aggressive pricing in another market to drive competitors out of that market.
13. Multipoint pricing refers to the fact that a firm's pricing strategy in one market may affect rivals' pricing strategies in another market. Aggressive pricing in one market may elicit a competitive response from a rival in another market that is important to the firm.
14. Experience curve pricing is the use of aggressive pricing to build accumulated volume as rapidly as possible to quickly move the firm down the experience curve.
15. New-product development is a high-risk, potentially high-return activity. To build a competency in new-product development, an international business must do two things: disperse R&D activities to those countries where new products are being pioneered, and integrate R&D with marketing and manufacturing.
16. Achieving tight integration among R&D, marketing, and manufacturing requires the use of cross-functional teams.

Critical Thinking and Discussion Questions

1. Imagine you are the marketing manager for a U.S. manufacturer of disposable diapers. Your firm is considering entering the Brazilian market. Your CEO believes the advertising message that has been effective in the United States will suffice in Brazil. Outline some possible objections to this. Your CEO also believes that the pricing decisions in Brazil can be delegated to local managers. Why might she be wrong?
2. Within 20 years, we will have seen the emergence of enormous global markets for standardized consumer products. Do you agree with this statement? Justify your answer.
3. You are the marketing manager of a food products company that is considering entering the Indian market. The retail system in India tends to be very fragmented. Also, retailers and wholesalers tend to have long-term ties with Indian food companies; these ties make access to distribution channels difficult. What distribution strategy would you advise the company to pursue? Why?
4. Price discrimination is indistinguishable from dumping. Discuss the accuracy of this statement.
5. You work for a company that designs and manufactures personal computers. Your company's R&D center is in North Dakota. The computers are manufactured under contract in Taiwan. Marketing strategy is delegated to the heads of three regional groups: a North American group (based in Chicago), a European group (based in Paris), and an Asian group (based in Singapore). Each regional group develops the marketing approach within its region. In order of importance, the largest markets for your products are North America, Germany, Great Britain, China, and Australia. Your company is experiencing problems in its product development and commercialization process. Products are late to market, the manufacturing quality is poor, costs are higher than projected, and market acceptance of new products is less than hoped for. What might be the source of these problems? How would you fix them?
6. Reread the Management Focus on Levi Strauss and then answer the following questions:
   a. What marketing strategy was Levi Strauss using until the early 2000s? Why did this strategy appear to work for decades? Why was it not working by the 2000s?
   b. How would you characterize Levi Strauss's current strategy? What elements of the marketing mix are now changed from nation to nation?
   c. What are the benefits of the company's new marketing strategy? Is there a downside?
   d. What does the Levi Strauss story tell you about the "globalization of markets"?

Research Task globalEDGE globaledge.msu.edu

Global Marketing and R&D

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The consumer purchase of specific brands is an indication of the relationship that develops over time between a company and its customers. Locate and retrieve the most current ranking of *global brands*. Identify the criteria used. Which countries appear to dominate the top 100 global brands list? Why do you think this is the case? Prepare a short report identifying the countries that possess global brands and the potential reasons for success. In addition, identify the traits of companies new to the list.

Exercise 2

Part of developing a long-term research and development (R&D) strategy is to locate facilities in countries which are widely known to be competitive. Your company seeks to develop R&D facilities in Asia to counter recent competitor responses. A publication which evaluates economies based on their competitiveness is the *Global Competitiveness Report*. Locate this report and develop a presentation for the top management team that presents the benefits and drawbacks for the top 5 Asian economies listed. Justify your conclusions thoroughly.

CLOSING CASE

Microsoft in India

Microsoft made its name by building two monopolies, its Windows operating system and its Office suite of personal productivity software, that are used the world over. Windows, for example, runs on about 94 percent of the world's personal computers. Despite its global dominance, however, Microsoft has found it difficult to get traction in many developing nations, including India. Although the country has a well-educated middle class, and although India is home to some of the world's most successful Information technology outsourcing companies, the vast majority of Indians do not have access to a personal computer. India has only 25 PCs per thousand people compared to 997 per thousand in the United States. The main reason for this is cost! Most Indians are simply too poor to afford a PC. Also, Microsoft's Windows franchise faces two major competitors in India: pirated versions of Windows and the free open source software product Linux, which can be found on many servers and also is making its way onto desktop PCs in India.

Dealing with these issues has forced Microsoft to rethink its global strategy of one size fits all. In many ways India has become a testing ground for Microsoft's efforts to customize its offerings to the realities of emerging markets. To help develop local offerings, Microsoft invested heavily in an Indian R&D center in Hyderabad, which today employs 1,500 people and is the company's largest software development center outside the United States.

To protect its Windows franchise against lower-cost competitors (pirates and Linux), Microsoft developed a special version of Windows, the Windows XP Starter Edition. This sells for less than half the price of Windows XP, which is itself cheaper than its recent operating systems, Windows Vista and Windows 7. Windows XP Starter Edition has limited functionality—it can run only three programs at once and is not configured for computer networking—but the low price is more appealing in the Indian market. Starter Edition comes in 10 local Indian languages, plus Hindi and English, significantly broadening its appeal.

With regard to other offerings, such as Office and SQL Server (Microsoft's database product), Microsoft, for a low subscription fee, is selling monthly online access instead of selling packaged software, which is too expensive for many small businesses. The programs are hosted on Microsoft servers. Not only does this strategy help Microsoft to gain incremental sales that would not otherwise occur, but it also is proving to be an effective response to pirates, who cannot offer a similar service. Ironically, this strategy may ultimately be one that is favored in developed markets, such as the United States, where competitors such as Google are starting to gain traction with similar online offerings.

Other innovate offerings in India include a product called Multipoint, which allows users to attach several computer mice to a single machine. The product is for use in schools and was developed after Microsoft observed very few Indians schools had one PC per student, and that students often lined up three or four deep behind a machine. Microsoft is developing simple educational programs that multiple students can interact with at the same time by clicking on icons. For example, children can play a game where they hear a word and then compete to identify the text on the screen that matches the sound.

More generally, Microsoft has observed that in India many people are using cell phones to perform basic functions that in other countries would be done using personal computers. The PC is still too expensive to be used by many small Indian businesses (20 people or less) that account for half of India's manufacturing. Cell phones are cheaper, they are mobile, and they are easy to use. To address this market, Microsoft is experimenting with a number of approaches. The company has created text-messaging services for farmers and manufacturers, enabling them to check prices, inventory levels, orders, and so on via their cell phones. For example, in 2008 it rolled out a project in Tirupur, a textile manufacturing center, enabling small manufacturers with cell phones to track progress with orders over the Internet via text messages. All the back-end server hardware and maintenance is outsourced to a local firm, while Microsoft charges users a monthly fee for the service. By pioneering locally customized services like these, Microsoft hopes to grow its share of the Indian software market.[49]

Case Discussion Questions

1. Why does Microsoft's traditional strategy of one size fits all not work well in emerging markets such as India? What is different about these markets? How do customers differ both in their characteristics, and in the way they use technology?
2. What steps did Microsoft take to develop products that are customized to Indian consumers?
3. How does Microsoft vary the marketing mix of its existing product offerings to gain traction with Indian customers? What else has Microsoft done to make headway in India?
4. What general lessons can be derived from Microsoft's experience in India?

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19 Global Human Resource Management

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Summarize the strategic role of human resource management in the international business.
- **LO2** Identify the pros and cons of different approaches to staffing policy in the international business.
- **LO3** Explain why managers may fail to thrive in foreign postings.
- **LO4** Recognize how management development and training programs can increase the value of human capital in the international business firm.
- **LO5** Explain how and why performance appraisal systems might vary across nations.
- **LO6** Understand how and why compensation systems might vary across nations.
- **LO7** Understand how organized labor can influence strategic choices in international business firms.

MMC China

It had been a very bad morning for John Ross, the general manager of MMC's Chinese joint venture. He had just got off the phone with his boss in St Louis, Phil Smith, who was demanding to know why the joint venture's return on investment was still in the low single digits four years after Ross had taken over the top post in the operation. "We had expected much better performance by now," said Smith, "particularly given your record of achievement; you need to fix this, Phil. Our patience is not infinite. You know the corporate goal is for a 20 percent return on investment for operating units, and your unit is not even close to that." Ross had a very bad feeling that Smith had just fired a warning shot across his bow. There was an implicit threat underlying Smith's demands for improved performance. For the first time in his 20-year career at MMC, Ross felt that his job was on the line.

MMC was a U.S.-based multinational electronics enterprise with sales of $2 billion and operations in more than 10 countries. MMC China specialized in the mass production of printed circuit boards for companies in the cell phone and computer industries. MMC was a joint venture with Shanghai Electronic Corporation, a former state-owned enterprise that held 49 percent of the joint-venture equity (MMC held the rest). While MMC held a majority of the equity, the company had to consult with its partner before making major investments or changing employment levels.

John Ross had been running MMC China for the past four years. He had arrived at MMC China after a very successful career at MMC, which included extended postings in Mexico and Hungary. When he took the China position, Ross thought that if he succeeded he would probably be in line for one of the top jobs at corporate headquarters within a few years. Ross had known that he was taking on a challenge with MMC China, but nothing prepared him for what he found there. The joint venture was a mess. Operations were horribly inefficient. Despite low wages, productivity was being killed by poor product quality, lax inventory controls, and high employee turnover. The venture probably employed too many people, but MMC's Chinese partner seemed to view the venture as a job-creation program, and repeatedly objected to any plans for cutting the workforce. To make matters worse, MMC China had failed to keep up with the latest developments in manufacturing technology and it was falling behind competitors. Ross was determined to change this, but it had not been easy.



To improve operations, Ross had put in a request to corporate HR for two specialists from the United States to work with the Chinese production employees. It had been a disaster. One had lasted three months before requesting a transfer home for personal reasons. Apparently, his spouse hated China. The other had stayed for a year, but he had interacted so poorly with the local Chinese employees that he had to be sent back to the United States. Ross wished that MMC's corporate HR department had done a better job of selecting and then training these employees for a difficult foreign posting, but in retrospect he had to admit that he wasn't surprised at the lack of cultural training; he had never been given any.

After this failure, Ross had taken a different tack. He had picked four of his best Chinese production employees and sent them to MMC's U.S. operations, along with a translator, for a two-month training program focusing on the latest production techniques. This had worked out much better. The Chinese had visited efficient MMC factories in the United States, Mexico, and Brazil and had seen what was possible. They had returned home fired up to improve operations at MMC China. Within a year they had introduced a Six Sigma quality control program and improved the flow of inventory through MMC's factory. Ross could now walk though the factory without being appalled by the sight of large quantities of inventory stacked on the floor or bins full of discarded circuit boards that had failed postassembly quality tests. Productivity had improved as a result and after three tough years, MMC China had finally turned a profit.

Apparently this was not good enough for corporate headquarters. Ross knew that improving performance further would be tough. The market in China was very competitive. MMC was vying with many other enterprises to produce printed circuit boards for large multinational customers that had assembly operations in China. The customers were constantly demanding lower prices, and it seemed to Ross that prices were falling almost as fast as MMC's costs. Also, Ross was limited in his ability to cut the workforce by the demands of his Chinese joint-venture partner. Ross had tried to explain all of this to Phil Smith, but Smith didn't seem to get it. "The man is just a number cruncher," thought Ross. "He has no sense of the market in China. He has no idea how hard it is to do business here. I have worked damn hard to turn this operation around, and I am getting no credit for it, none at all."[1]

Introduction

This chapter continues our survey of specific functions within an international business by looking at international human resource management (HRM). **Human resource management** refers to the activities an organization carries out to use its human resources effectively.[2] These activities include determining the firm's human resource strategy, staffing, performance evaluation, management development, compensation, and labor relations. None of these activities is performed in a vacuum; all are related to the strategy of the firm. As we will see, HRM has an important strategic component.[3] Through its influence on the character, development, quality, and productivity of the firm's human resources, the HRM function can help the firm achieve its primary strategic goals of reducing the costs of value creation and adding value by better serving customers.

The opening case described what can happen when the HRM function does not perform as well as it might. MMC sent two expatriates to MMC China to help the beleaguered boss of that unit, John Ross, but neither expatriate was successful. Apparently the HR department had picked two employees that were well qualified from a technical perspective, but were not suited to a difficult foreign posting. This is not unusual. As we shall see, a large number of expatriates return home before their tour of duty is completed, often because while they have the technical skills to perform the required job, they lack the skills required to manage in a different cultural context, or because their spouses do not like the posting. To his credit, Ross came up with a solution to the problem: send Chinese employees to the United States to be trained in the latest manufacturing techniques. The MMC case also illustrates another problem in international HRM: how to evaluate the performance of expatriate managers who are operating in very different circumstances from those found in the home country. It is apparent from the case that John Ross was being evaluated on the basis of the performance of his unit against corporatewide profitability criteria, but these criteria failed to account for the difficult conditions Ross inherited and the problems inherent in doing business in the Chinese market. The most skilled multinationals have found ways of dealing with this problem and adjust performance appraisal criteria to take differences in context into account. MMC apparently did not do this.

Irrespective of the desire of managers in many multinationals to build a truly global enterprise with a global workforce, the reality is that HRM practices still have to be modified to national context. The strategic role of HRM is complex enough in a purely domestic firm, but it is more complex in an international business, where staffing, management development, performance evaluation, and compensation activities are complicated by profound differences between countries in labor markets, culture, legal systems, economic systems, and the like (see Chapters 2–4). For example,

- Compensation practices may vary from country to country, depending on prevailing management customs.
- Labor laws may prohibit union organization in one country and mandate it in another.
- Equal employment legislation may be strongly pursued in one country and not in another.

If it is to build a cadre of managers capable of managing a multinational enterprise, the HRM function must deal with a host of issues. It must decide how to staff key management posts in the company, how to develop managers so that they are familiar with the nuances of doing business in different countries, how to compensate people in different nations, and how to evaluate the performance of managers based in different countries. HRM must also deal with a host of issues related to expatriate managers. (An **expatriate manager** is a citizen of one country who is working abroad in one of the firm's subsidiaries.) It must decide when to use expatriates, determine whom to send on

expatriate postings, be clear about why they are doing it, compensate expatriates appropriately, and make sure that they are adequately debriefed and reoriented once they return home.

This chapter looks closely at the role of HRM in an international business. It begins by briefly discussing the strategic role of HRM. Then we turn our attention to four major tasks of the HRM function: staffing policy, management training and development, performance appraisal, and compensation policy. We will point out the strategic implications of each of these tasks. The chapter closes with a look at international labor relations and the relationship between the firm's management of labor relations and its overall strategy.

The Strategic Role of International HRM

LO1

A large and expanding body of academic research suggests that a strong fit between human resources practices and strategy is required for high profitability.[4] You will recall from Chapter 13 that superior performance requires not only the right strategy, but the strategy must also be supported by the right organization architecture. Strategy is implemented through organization. As shown in Figure 19.1 (which is based on Figure 14.1), people are the linchpin of a firm's organization architecture. For a firm to outperform its rivals in the global marketplace, it must have the right people in the right postings. Those people must be trained appropriately so that they have the skill sets required to perform their jobs effectively, and so that they behave in a manner that is congruent with the desired culture of the firm. Their compensation packages must create incentives for them to take actions that are consistent with the strategy of the firm, and the performance appraisal system the firm uses must measure the behavior that the firm wants to encourage.

As indicated in Figure 19.1, the HRM function, through its staffing, training, compensation, and performance appraisal activities, has a critical impact upon the people, culture, incentive, and control system elements of the firm's organization architecture (performance appraisal systems are part of the control systems in an enterprise). Thus, HRM professionals have a critically important strategic role. It is incumbent upon them to shape these elements of a firm's organization architecture in a manner that is consistent with the strategy of the enterprise, so that the firm can effectively implement its strategy.

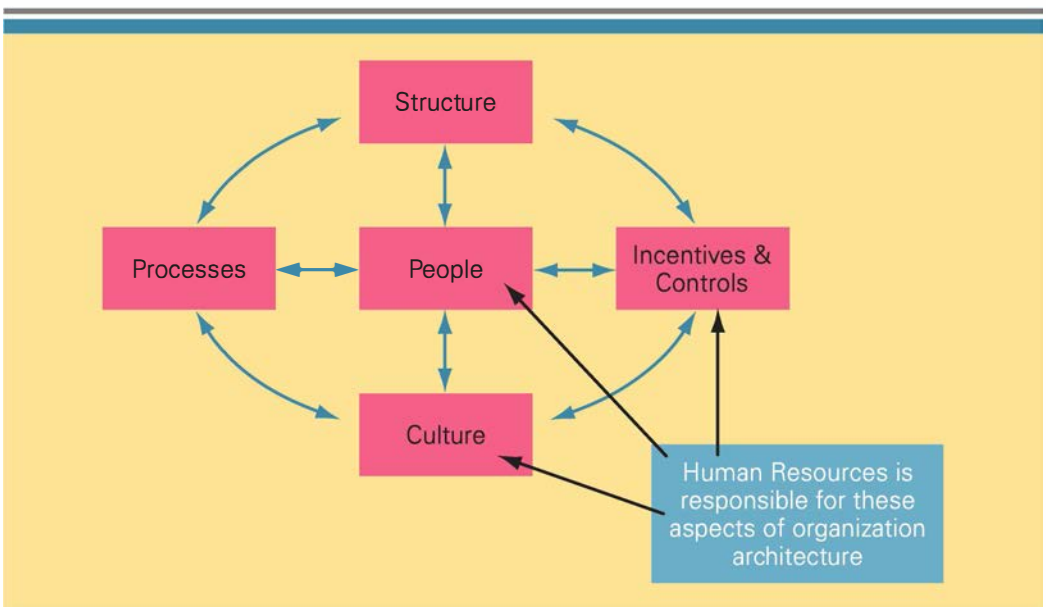

FIGURE 19.1

The Role of Human Resources in Shaping Organization Architecture

In short, superior human resource management can be a sustained source of high productivity and competitive advantage in the global economy. At the same time, research suggests that many international businesses have room for improving the effectiveness of their HRM function. In one study of competitiveness among 326 large multinationals, the authors found that human resource management was one of the weakest capabilities in most firms, suggesting that improving the effectiveness of international HRM practices might have substantial performance benefits.[5]

In Chapter 13, we examined four strategies pursued by international businesses: localization strategy, international strategy, global standardization strategy, and transnational strategy. Firms that emphasize localization try to create value by emphasizing local responsiveness; international firms, by transferring products and competencies overseas; global firms, by realizing experience curve and location economies; and transnational firms, by doing all these things simultaneously. In this chapter, we will see that success also requires HRM policies to be congruent with the firm's strategy. For example, a transnational strategy imposes different requirements for staffing, management development, and compensation practices than a localization strategy. Firms pursuing a transnational strategy need to build a strong corporate culture and an informal management network for transmitting information and knowledge within the organization. Through its employee selection, management development, performance appraisal, and compensation policies, the HRM function can help develop these things. Thus, as we have noted, HRM has a critical role to play in implementing strategy. In each section that follows, we will review the strategic role of HRM in some detail.

LO2 Staffing Policy

Staffing policy is concerned with the selection of employees for particular jobs. At one level, this involves selecting individuals who have the skills required to do particular jobs. At another level, staffing policy can be a tool for developing and promoting the desired corporate culture of the firm.[6] By **corporate culture**, we mean the organization's norms and value systems. A strong corporate culture can help a firm implement its strategy. General Electric, for example, is not just concerned with hiring people who have the skills required for performing particular jobs; it wants to hire individuals whose behavioral styles, beliefs, and value systems are consistent with those of GE. This is true whether an American is being hired, an Italian, a German, or an Australian and whether the hiring is for a U.S. operation or a foreign operation. The belief is that if employees are predisposed toward the organization's norms and value systems by their personality type, the firm will be able to attain higher performance.

TYPES OF STAFFING POLICY

Research has identified three types of staffing policies in international businesses: the ethnocentric approach, the polycentric approach, and the geocentric approach.[7] We will review each policy and link it to the strategy pursued by the firm. The most attractive staffing policy is probably the geocentric approach, although there are several impediments to adopting it.

The Ethnocentric Approach

An **ethnocentric staffing policy** is one in which all key management positions are filled by parent-country nationals. This practice was widespread at one time. Firms such as Procter & Gamble, Philips Electronics NV, and Matsushita (now called Panasonic) originally followed it. In the Dutch firm Philips, for example, all important positions in most foreign subsidiaries were at one time held by Dutch nationals, who were referred to by their non-Dutch colleagues as the Dutch Mafia. Historically in many Japanese and South Korean firms, such as Toyota, Matsushita, and Samsung, key positions in

international operations have often been held by home-country nationals. For example, according to the Japanese Overseas Enterprise Association, only 29 percent of foreign subsidiaries of Japanese companies had presidents who were not Japanese. In contrast, 66 percent of the Japanese subsidiaries of foreign companies had Japanese presidents.[8] Today, there is evidence that as Chinese enterprises are expanding internationally, they too are using an ethnocentric staffing policy in their foreign operations.[9]

Firms pursue an ethnocentric staffing policy for three reasons. First, the firm may believe the host country lacks qualified individuals to fill senior management positions. This argument is heard most often when the firm has operations in less developed countries. Second, the firm may see an ethnocentric staffing policy as the best way to maintain a unified corporate culture. Many Japanese firms, for example, have traditionally preferred their foreign operations to be headed by expatriate Japanese managers because these managers will have been socialized into the firm's culture while employed in Japan.[10] Procter & Gamble until fairly recently preferred to staff important management positions in its foreign subsidiaries with U.S. nationals who had been socialized into P&G's corporate culture by years of employment in its U.S. operations. Such reasoning tends to predominate when a firm places a high value on its corporate culture.

Third, if the firm is trying to create value by transferring core competencies to a foreign operation, as firms pursuing an international strategy are, it may believe that the best way to do this is to transfer parent-country nationals who have knowledge of that competency to the foreign operation. Imagine what might occur if a firm tried to transfer a core competency in marketing to a foreign subsidiary without a corresponding transfer of home-country marketing management personnel. The transfer would probably fail to produce the anticipated benefits because the knowledge underlying a core competency cannot easily be articulated and written down. Such knowledge often has a significant tacit dimension; it is acquired through experience. Just like the great tennis player who cannot instruct others how to become great tennis players simply by writing a handbook, the firm that has a core competency in marketing, or anything else, cannot just write a handbook that tells a foreign subsidiary how to build the firm's core competency anew in a foreign setting. It must also transfer management personnel to the foreign operation to show foreign managers how to become good marketers, for example. The need to transfer managers overseas arises because the knowledge that underlies the firm's core competency resides in the heads of its domestic managers and was acquired through years of experience, not by reading a handbook. Thus, if a firm is to transfer a core competency to a foreign subsidiary, it must also transfer the appropriate managers.

Despite this rationale for pursuing an ethnocentric staffing policy, the policy is now on the wane in most international businesses for two reasons. First, an ethnocentric staffing policy limits advancement opportunities for host-country nationals. This can lead to resentment, lower productivity, and increased turnover among that group. Resentment can be greater still if, as often occurs, expatriate managers are paid significantly more than home-country nationals.

Second, an ethnocentric policy can lead to *cultural myopia*, the firm's failure to understand host-country cultural differences that require different approaches to marketing and management. The adaptation of expatriate managers can take a long time, during which they may make major mistakes. For example, expatriate managers may fail to appreciate how product attributes, distribution strategy, communications strategy, and pricing strategy should be adapted to host-country conditions. The result may be costly blunders. They may also make decisions that are ethically suspect simply because they do not understand the culture in which they are managing.[11] In one highly publicized case in the United States, Mitsubishi Motors was sued by the federal Equal Employment Opportunity Commission for tolerating extensive and systematic sexual harassment in a plant in Illinois. The plant's top management, all Japanese expatriates, denied the charges. The Japanese managers may have failed to realize that behavior that would be viewed as acceptable in Japan was not acceptable in the United States.[12]

The Polycentric Approach

A **polycentric staffing policy** requires host-country nationals to be recruited to manage subsidiaries, while parent-country nationals occupy key positions at corporate headquarters. In many respects, a polycentric approach is a response to the shortcomings of an ethnocentric approach. One advantage of adopting a polycentric approach is that the firm is less likely to suffer from cultural myopia. Host-country managers are unlikely to make the mistakes arising from cultural misunderstandings to which expatriate managers are vulnerable. A second advantage is that a polycentric approach may be less expensive to implement, reducing the costs of value creation. Expatriate managers can be expensive to maintain.

A polycentric approach also has its drawbacks. Host-country nationals have limited opportunities to gain experience outside their own country and thus cannot progress beyond senior positions in their own subsidiary. As in the case of an ethnocentric policy, this may cause resentment. Perhaps the major drawback with a polycentric approach, however, is the gap that can form between host-country managers and parent-country managers. Language barriers, national loyalties, and a range of cultural differences may isolate the corporate headquarters staff from the various foreign subsidiaries. The lack of management transfers from home to host countries, and vice versa, can exacerbate this isolation and lead to a lack of integration between corporate headquarters and foreign subsidiaries. The result can be a "federation" of largely independent national units with only nominal links to the corporate headquarters. Within such a federation, the coordination required to transfer core competencies or to pursue experience curve and location economies may be difficult to achieve. Thus, although a polycentric approach may be effective for firms pursuing a localization strategy, it is inappropriate for other strategies.

The federation that may result from a polycentric approach can also be a force for inertia within the firm. After decades of pursuing a polycentric staffing policy, food and detergents giant Unilever found that shifting from a strategic posture that emphasized localization to a transnational posture was very difficult. Unilever's foreign subsidiaries had evolved into quasi-autonomous operations, each with its own strong national identity. These "little kingdoms" objected strenuously to corporate headquarters' attempts to limit their autonomy and to rationalize global manufacturing.[13]

The Geocentric Approach

A **geocentric staffing policy** seeks the best people for key jobs throughout the organization, regardless of nationality. This policy has a number of advantages. First, it enables the firm to make the best use of its human resources. Second, and perhaps more important, a geocentric policy enables the firm to build a cadre of international executives who feel at home working in a number of cultures. Creation of such a cadre may be a critical first step toward building a strong unifying corporate culture and an informal management network, both of which are required for global standardization and transnational strategies.[14] Firms pursuing a geocentric staffing policy may be better able to create value from the pursuit of experience curve and location economies and from the multidirectional transfer of core competencies than firms pursuing other staffing policies. In addition, the multinational composition of the management team that results from geocentric staffing tends to reduce cultural myopia and to enhance local responsiveness.

In sum, other things being equal, a geocentric staffing policy seems the most attractive. Indeed, in recent years there has been a sharp shift toward adoption of a geocentric staffing policy by many multinationals. For example, India's Tata Group, now a $70 billion global conglomerate, runs several of its companies with American and British executives. Japan's Sony Corporation broke 60 years of tradition in 2005 when it installed its first non-Japanese chairman and CEO, Howard Stringer, a former CBS president and a U.S. citizen who was born and raised in Wales. American companies increasingly draw their managerial talent from overseas. One study found that by the

mid-2000s, 24 percent of the managers among the top 100 to 250 people in U.S. companies were from outside the United States. For European companies the average is 40 percent.[15]

However, a number of problems limit the firm's ability to pursue a geocentric policy. Many countries want foreign subsidiaries to employ their citizens. To achieve this goal, they use immigration laws to require the employment of host-country nationals if they are available in adequate numbers and have the necessary skills. Most countries, including the United States, require firms to provide extensive documentation if they wish to hire a foreign national instead of a local national. This documentation can be time consuming, expensive, and at times futile. A geocentric staffing policy also can be expensive to implement. Training and relocation costs increase when transferring managers from country to country. The company may also need a compensation structure with a standardized international base pay level higher than national levels in many countries. In addition, the higher pay enjoyed by managers placed on an international fast track may be a source of resentment within a firm.

Summary

The advantages and disadvantages of the three approaches to staffing policy are summarized in Table 19.1. Broadly speaking, an ethnocentric approach is compatible with an international strategy, a polycentric approach is compatible with a localization strategy, and a geocentric approach is compatible with both global standardization and transnational strategies. (See Chapter 13 for details of the strategies.)

While the staffing policies described here are well known and widely used among both practitioners and scholars of international businesses, some critics have claimed that the typology is too simplistic and that it obscures the internal differentiation of management practices within international businesses. The critics claim that within some international businesses, staffing policies vary significantly from national subsidiary to national subsidiary; while some are managed on an ethnocentric basis, others are managed in a polycentric or geocentric manner.[16] Other critics note that the staffing policy adopted by a firm is primarily driven by its geographic scope, as opposed to its strategic orientation. Firms that have a broad geographic scope are the most likely to have a geocentric mind-set.[17]

TABLE 19.1

Comparison of Staffing Approaches

Staffing Approach	Strategic Appropriateness	Advantages	Disadvantages
Ethnocentric	International	Overcomes lack of qualified managers in host nation Unified culture Helps transfer core competencies	Produces resentment in host country Can lead to cultural myopia
Polycentric	Localization	Alleviates cultural myopia Inexpensive to implement	Limits career mobility Isolates headquarters from foreign subsidiaries
Geocentric	Global standardization and transnational	Uses human resources efficiently Helps build strong culture and informal management networks	National immigration policies may limit implementation Expensive

LO3 EXPATRIATE MANAGERS

Two of the three staffing policies we have discussed—the ethnocentric and the geocentric—rely on extensive use of expatriate managers. As defined earlier, expatriates are citizens of one country who are working in another country. Sometimes the term *inpatriates* is used to identify a subset of expatriates who are citizens of a foreign country working in the home country of their multinational employer.[18] Thus, a citizen of Japan who moves to the United States to work at Microsoft would be classified as an inpatriate (Microsoft has large numbers of inpatriates working at its main U.S. location near Seattle). With an ethnocentric policy, the expatriates are all home-country nationals who are transferred abroad. With a geocentric approach, the expatriates need not be home-country nationals; the firm does not base transfer decisions on nationality. A prominent issue in the international staffing literature is **expatriate failure**—the premature return of an expatriate manager to his or her home country.[19] Here we briefly review the evidence on expatriate failure before discussing a number of ways to minimize the failure rate.

Expatriate Failure Rates

Expatriate failure represents a failure of the firm's selection policies to identify individuals who will not thrive abroad.[20] The consequences include premature return from a foreign posting and high resignation rates, with expatriates leaving their company at about twice the rate of domestic managers.[21] Research suggests that between 16 and 40 percent of all American employees sent abroad to developed nations return from their assignments early, and almost 70 percent of employees sent to developing nations return home early.[22] Although detailed data are not available for most nationalities, one suspects that high expatriate failure is a universal problem. Some 28 percent of British expatriates, for example, are estimated to fail in their overseas postings.[23] The costs of expatriate failure are high. One estimate is that the average cost per failure to the parent firm can be as high as three times the expatriate's annual domestic salary plus the cost of relocation (which is affected by currency exchange rates and location of assignment). Estimates of the costs of each failure run between $40,000 and $1 million.[24] In addition, approximately 30 to 50 percent of American expatriates, whose average annual compensation package runs to $250,000, stay at their international assignments but are considered ineffective or marginally effective by their firms.[25] In a seminal study, R. L. Tung surveyed a number of U.S., European, and Japanese multinationals.[26] Her results, summarized in Table 19.2, show that 76 percent of U.S. multinationals experienced

TABLE 19.2

Expatriate Failure Rates

Recall Rate Percent	Percent of Companies
U.S. multinationals	
20–40%	7%
10–20	69
<10	24
European multinationals	
11–15%	3%
6–10	38
<5	59
Japanese multinationals	
11–19%	14%
6–10	10
<5	76

Source: Data from R. L. Tung, "Selection and Training Procedures of U.S., European, and Japanese Multinationals," pp. 51–71. Copyright © by The Regents of the University of California. Reprinted from the *California Management Review* 1.25, no. 1, by permission from The Regents.

expatriate failure rates of 10 percent or more, and 7 percent experienced a failure rate of more than 20 percent. Tung's work also suggests that U.S.-based multinationals experience a much higher expatriate failure rate than either European or Japanese multinationals.

Tung asked her sample of multinational managers to indicate reasons for expatriate failure. For U.S. multinationals, the reasons, in order of importance, were

1. Inability of spouse to adjust.
2. Manager's inability to adjust.
3. Other family problems.
4. Manager's personal or emotional maturity.
5. Inability to cope with larger overseas responsibilities.

Managers of European firms gave only one reason consistently to explain expatriate failure: the inability of the manager's spouse to adjust to a new environment. For the Japanese firms, the reasons for failure were

1. Inability to cope with larger overseas responsibilities.
2. Difficulties with new environment.
3. Personal or emotional problems.
4. Lack of technical competence.
5. Inability of spouse to adjust.

The most striking difference between these lists is that "inability of spouse to adjust" was the top reason for expatriate failure among U.S. and European multinationals but only the No. 5 reason among Japanese multinationals. Tung comments that this difference was not surprising, given the role and status to which Japanese society traditionally relegates the wife and the fact that most of the Japanese expatriate managers in the study were men.

Since Tung's study, a number of other studies have consistently confirmed that the inability of a spouse to adjust, the inability of the manager to adjust, or other family problems remain major reasons for continuing high levels of expatriate failure.[27] One study by International Orientation Resources, an HRM consulting firm, found that 60 percent of expatriate failures occur due to these three reasons.[28] Another study found that the most common reason for assignment failure is lack of partner (spouse) satisfaction, which was listed by 27 percent of respondents.[29] The inability of expatriate managers to adjust to foreign postings seems to be caused by a lack of cultural skills on the part of the manager being transferred. According to one HRM consulting firm, this is because the expatriate selection process at many firms is fundamentally flawed. "Expatriate assignments rarely fail because the person cannot accommodate to the technical demands of the job. Typically, the expatriate selections are made by line managers based on technical competence. They fail because of family and personal issues and lack of cultural skills that haven't been part of the selection process."[30]

The failure of spouses to adjust to a foreign posting seems to be related to a number of factors. Often spouses find themselves in a foreign country without the familiar network of family and friends. Language differences make it difficult for them to make new friends. While this may not be a problem for the manager, who can make friends at work, it can be difficult for the spouse, who might feel trapped at home. The problem is often exacerbated by immigration regulations prohibiting the spouse from taking employment. With the recent rise of two-career families in many developed nations, this issue has become much more important. One survey found that 69 percent of expatriates are married, with spouses accompanying them 77 percent of the time. Of those spouses, 49 percent were employed before an assignment and only 11 percent were employed during an assignment.[31] Research suggests that a main reason managers now turn down international assignments is concern over the impact such an assignment might have on their



MANAGEMENT FOCUS

Managing Expatriates at Royal Dutch/Shell

Royal Dutch/Shell is a global petroleum company with joint headquarters in both London and The Hague in the Netherlands. The company employs more than 100,000 people, approximately 5,500 of whom are at any one time living and working as expatriates. The expatriates at Shell are a diverse group, made up of over 70 nationalities and located in more than 100 countries. Shell, as a global corporation, has long recognized that the international mobility of its workforce is essential to its success. By the 1990s, however, Shell was finding it harder to recruit key personnel for foreign postings. To discover why, the company interviewed more than 200 expatriate employees and their spouses to determine their biggest concerns. The data were then used to construct a survey that was sent to 17,000 current and former expatriate employees, expatriates' spouses, and employees who had declined international assignments.

The survey registered a phenomenal 70 percent response rate, clearly indicating that many employees thought this was an important issue. According to the survey, five issues had the greatest impact on the willingness of an employee to accept an international assignment. In order of importance, these were (1) separation from children during their secondary education (the children of British and Dutch expatriates were often sent to boarding schools in their home countries while their parents worked abroad), (2) harm done to a spouse's career and employment, (3) failure to recognize and involve a spouse in the relocation decision, (4) failure to provide adequate information and assistance regarding relocation, and (5) health issues. The underlying message was that the family is the basic unit of expatriation, not the individual, and Shell needed to do more to recognize this.

To deal with these issues, Shell implemented a number of programs designed to address some of these problems. To help with the education of children, Shell built elementary schools for Shell employees where there was a heavy concentration of expatriates. As for secondary school education, it worked with local schools, often providing grants, to help them upgrade their educational offerings. It also offered an education supplement to help expatriates send their children to private schools in the host country.

Helping spouses with their careers is a more vexing problem. According to the survey data, half of the spouses accompanying Shell staff on assignment were employed until the transfer. When expatriated, only 12 percent were able to secure employment, while a further 33 percent wished to be employed. Shell set up a spouse employment center to address the problem. The center provides career counseling and assistance in locating employment opportunities both during and immediately after an international assignment. The company also agreed to reimburse up to 80 percent of the costs of vocational training, further education, or reaccreditation, up to $4,400 per assignment.

Shell also set up a global information and advice network known as "The Outpost" to provide support for families contemplating a foreign posting. The Outpost has its headquarters in The Hague and now runs 40 information centers in more than 30 countries. The center recommends schools and medical facilities and provides housing advice and up-to-date information on employment, study, self-employment, and volunteer work.[33]

spouse's career.[32] The accompanying Management Focus examines how one large multinational company, Royal Dutch/Shell, has tried to come to grips with this issue.

Expatriate Selection

One way to reduce expatriate failure rates is by improving selection procedures to screen out inappropriate candidates. In a review of the research on this issue, Mendenhall and Oddou state that a major problem in many firms is that HRM managers tend to equate domestic performance with overseas performance potential.[34] Domestic performance and overseas performance potential are *not* the same thing. An executive who performs well in a domestic setting may not be able to adapt to managing in a different cultural setting.

From their review of the research, Mendenhall and Oddou identified four dimensions that seem to predict success in a foreign posting: self-orientation, others-orientation, perceptual ability, and cultural toughness.

1. *Self-orientation*. The attributes of this dimension strengthen the expatriate's self-esteem, self-confidence, and mental well-being. Expatriates with high self-esteem, self-confidence, and mental well-being were more likely to succeed in foreign postings. Mendenhall and Oddou concluded that such individuals were able to adapt their interests in food, sport, and music; had interests outside of work that could be pursued (e.g., hobbies); and were technically competent.
2. *Others-orientation*. The attributes of this dimension enhance the expatriate's ability to interact effectively with host-country nationals. The more effectively the expatriate interacts with host-country nationals, the more likely he or she is to succeed. Two factors seem to be particularly important here: relationship development and willingness to communicate. Relationship development refers to the ability to develop long-lasting friendships with host-country nationals. Willingness to communicate refers to the expatriate's willingness to use the host-country language. Although language fluency helps, an expatriate need not be fluent to show willingness to communicate. Making the effort to use the language is what is important. Such gestures tend to be rewarded with greater cooperation by host-country nationals.
3. *Perceptual ability*. This is the ability to understand why people of other countries behave the way they do, that is, the ability to empathize. This dimension seems critical for managing host-country nationals. Expatriate managers who lack this ability tend to treat foreign nationals as if they were home-country nationals. As a result, they may experience significant management problems and considerable frustration. As one expatriate executive from Hewlett-Packard observed, "It took me six months to accept the fact that my staff meetings would start 30 minutes late, and that it would bother no one but me." According to Mendenhall and Oddou, well-adjusted expatriates tend to be nonjudgmental and nonevaluative in interpreting the behavior of host-country nationals and willing to be flexible in their management style, adjusting it as cultural conditions warrant.
4. *Cultural toughness*. This dimension refers to the relationship between the country of assignment and how well an expatriate adjusts to a particular posting. Some countries are much tougher postings than others because their cultures are more unfamiliar and uncomfortable. For example, many Americans regard Great Britain as a relatively easy foreign posting, and for good reason—the two cultures have much in common. But many Americans find postings in non-Western cultures, such as India, Southeast Asia, and the Middle East, to be much tougher.[35] The reasons are many, including poor health care and housing standards, inhospitable climate, lack of Western entertainment, and language difficulties. Also, many cultures are extremely male-dominated and may be particularly difficult postings for female Western managers.

THE GLOBAL MIND-SET

Some researchers suggest that a global mind-set, one characterized by cognitive complexity and a cosmopolitan outlook, is the fundamental attribute of a global manager. Such managers can deal with high levels of complexity and ambiguity and are open to the world. How do you develop these attributes? Often they are gained in early life, from a family that is bicultural, lives in foreign countries, or learns foreign languages as a regular part of family life.

Mendenhall and Oddou note that standard psychological tests can be used to assess the first three of these dimensions, whereas a comparison of cultures can give managers

a feeling for the fourth dimension. They contend that these four dimensions, in addition to domestic performance, should be considered when selecting a manager for foreign posting. However, practice does not often conform to Mendenhall and Oddou's recommendations. Tung's research, for example, showed that only 5 percent of the firms in her sample used formal procedures and psychological tests to assess the personality traits and relational abilities of potential expatriates.[36] Research by International Orientation Resources suggests that when selecting employees for foreign assignments, only 10 percent of the 50 Fortune 500 firms surveyed tested for important psychological traits such as cultural sensitivity, interpersonal skills, adaptability, and flexibility. Instead, 90 percent of the time employees were selected on the basis of their technical expertise, not their cross-cultural fluency.[37]

Mendenhall and Oddou do not address the problem of expatriate failure due to a spouse's inability to adjust. According to a number of other researchers, a review of the family situation should be part of the expatriate selection process (see the Management Focus on Royal Dutch/Shell for an example).[38] A survey by Windam International, another international HRM consulting firm, found that spouses were included in preselection interviews for foreign postings only 21 percent of the time, and that only half of them received any cross-cultural training. The rise of dual-career families has added an additional and difficult dimension to this long-standing problem.[39] Increasingly, spouses wonder why they should have to sacrifice their own career to further that of their partner.[40]

LO4 Training and Management Development

Selection is just the first step in matching a manager with a job. The next step is training the manager to do the specific job. For example, an intensive training program might be used to give expatriate managers the skills required for success in a foreign posting. However, management development is a much broader concept. It is intended to develop the manager's skills over his or her career with the firm. Thus, as part of a management development program, a manager might be sent on several foreign postings over a number of years to build his or her cross-cultural sensitivity and experience. At the same time, along with other managers in the firm, the person might attend management education programs at regular intervals. The thinking behind job transfers is that broad international experience will enhance the management and leadership skills of executives. Research suggests this may be the case.[41]

Historically, most international businesses have been more concerned with training than with management development. Plus, they tended to focus their training efforts on preparing home-country nationals for foreign postings. Recently, however, the shift toward greater global competition and the rise of transnational firms have changed this. It is increasingly common for firms to provide general management development programs in addition to training for particular posts. In many international businesses, the explicit purpose of these management development programs is strategic. Management development is seen as a tool to help the firm achieve its strategic goals, not only by giving managers the required skill set, but also by helping to reinforce the desired culture of the firm and by facilitating the creation of an informal network for sharing knowledge within the multinational enterprise.



International businesses, such as Caterpillar, are increasingly providing general management development programs in addition to training for particular foreign postings.

With this distinction between training and management development in mind, we first examine the types of training managers receive for foreign postings. Then we discuss the connection between management development and strategy in the international business.

TRAINING FOR EXPATRIATE MANAGERS

Earlier in the chapter we saw that the two most common reasons for expatriate failure were the inability of a manager's spouse to adjust to a foreign environment and the manager's own inability to adjust to a foreign environment. Training can help the manager and spouse cope with both of these problems. Cultural training, language training, and practical training all seem to reduce expatriate failure. We discuss each of these kinds of training here.[42] Despite the usefulness of these kinds of training, evidence suggests that many managers receive no training before they are sent on foreign postings. One study found that only about 30 percent of managers sent on one- to five-year expatriate assignments received training before their departure.[43]

Cultural Training

Cultural training seeks to foster an appreciation for the host country's culture. The belief is that understanding a host country's culture will help the manager empathize with the culture, which will enhance his or her effectiveness in dealing with host-country nationals. It has been suggested that expatriates should receive training in the host country's culture, history, politics, economy, religion, and social and business practices.[44] If possible, it is also advisable to arrange for a familiarization trip to the host country before the formal transfer, as this seems to ease culture shock. Given the problems related to spouse adaptation, it is important that the spouse, and perhaps the whole family, be included in cultural training programs.

Language Training

English is the language of world business; it is quite possible to conduct business all over the world using only English. Notwithstanding the prevalence of English, however, an exclusive reliance on English diminishes an expatriate manager's ability to interact with host-country nationals. As noted earlier, a willingness to communicate in the language of the host country, even if the expatriate is far from fluent, can help build rapport with local employees and improve the manager's effectiveness. Despite this, one study of 74 executives of U.S. multinationals found that only 23 believed knowledge of foreign languages was necessary for conducting business abroad.[45] Those firms that did offer foreign language training for expatriates believed it improved their employees' effectiveness and enabled them to relate more easily to a foreign culture, which fostered a better image of the firm in the host country.

Practical Training

Practical training is aimed at helping the expatriate manager and family ease themselves into day-to-day life in the host country. The sooner a routine is established, the better are the prospects that the expatriate and his or her family will adapt successfully. One critical need is for a support network of friends for the expatriate. Where an expatriate community exists, firms often devote considerable effort to ensuring the new expatriate family is quickly integrated into that group. The expatriate community can be a useful source of support and information and can be invaluable in helping the family adapt to a foreign culture.



Lenovo decided that English was to be the official language of the company, even though it is a Chinese enterprise.

REPATRIATION OF EXPATRIATES

A largely overlooked but critically important issue in the training and development of expatriate managers is to prepare them for reentry into their home-country organization.[46] Repatriation should be seen as the final link in

an integrated, circular process that connects good selection and cross-cultural training of expatriate managers with completion of their term abroad and reintegration into their national organization. However, instead of having employees come home to share their knowledge and encourage other high-performing managers to take the same international career track, expatriates too often face a different scenario.[47]

Often when they return home after a stint abroad—where they have typically been autonomous, well-compensated, and celebrated as a big fish in a little pond—they face an organization that doesn't know what they have done for the past few years, doesn't know how to use their new knowledge, and doesn't particularly care. In the worst cases, reentering employees have to scrounge for jobs, or firms will create standby positions that don't use the expatriate's skills and capabilities and fail to make the most of the business investment the firm has made in that individual.

Research illustrates the extent of this problem. According to one study of repatriated employees, 60 to 70 percent didn't know what their position would be when they returned home. Also, 60 percent said their organizations were vague about repatriation, about their new roles, and about their future career progression within the company; 77 percent of those surveyed took jobs at a lower level in their home organization than in their international assignments.[48] Not surprisingly, 15 percent of returning expatriates leave their firms within a year of arriving home, and 40 percent leave within three years.[49]

The key to solving this problem is good human resource planning. Just as the HRM function needs to develop good selection and training programs for its expatriates, it also needs to develop good programs for reintegrating expatriates back into work life within their home-country organization, for preparing them for changes in their physical and professional landscape, and for utilizing the knowledge they acquired while abroad. For an example of the kind of program that might be used, see the accompanying Management Focus that looks at the repatriation program developed by Monsanto.

MANAGEMENT DEVELOPMENT AND STRATEGY

Management development programs are designed to increase the overall skill levels of managers through a mix of ongoing management education and rotations of managers through a number of jobs within the firm to give them varied experiences. They are attempts to improve the overall productivity and quality of the firm's management resources.

International businesses increasingly are using management development as a strategic tool. This is particularly true in firms pursuing a transnational strategy, as increasing numbers are. Such firms need a strong unifying corporate culture and informal management networks to assist in coordination and control. In addition, transnational firm managers need to be able to detect pressures for local responsiveness, and that requires them to understand the culture of a host country.

Management development programs help build a unifying corporate culture by socializing new managers into the norms and value systems of the firm. In-house company training programs and intense interaction during off-site training can foster esprit de corps—shared experiences, informal networks, perhaps a company language or jargon—as well as develop technical competencies. These training events often include songs, picnics, and sporting events that promote feelings of togetherness. These rites of integration may include "initiation rites" wherein personal culture is stripped, company uniforms are donned (e.g., T-shirts bearing the company logo), and humiliation is inflicted (e.g., a pie in the face). All these activities aim to strengthen a manager's identification with the company.[50]

Bringing managers together in one location for extended periods and rotating them through different jobs in several countries helps the firm build an informal management network. Such a network can then be used as a conduit for exchanging valuable

MANAGEMENT FOCUS

Monsanto's Repatriation Program

Monsanto is a global provider of agricultural products with 10,000 employees. At any one time, the company will have 100 mid- and higher-level managers on extended postings abroad. Two-thirds of these are Americans posted overseas; the remainder are foreign nationals employed in the United States. At Monsanto, managing expatriates and their repatriation begins with a rigorous selection process and intensive cross-cultural training, both for the managers and for their families. As at many other global companies, the idea is to build an internationally minded cadre of highly capable managers who will lead the organization in the future.

One of the strongest features of this program is that employees and their sending and receiving managers, or sponsors, develop an agreement about how this assignment will fit into the firm's business objectives. The focus is on why employees are going abroad to do the job and what their contribution to Monsanto will be when they return. Sponsoring managers are expected to be explicit about the kind of job opportunities the expatriates will have once they return home.

Once they arrive back in their home country, expatriate managers meet with cross-cultural trainers during debriefing sessions. They are also given the opportunity to showcase their experiences to their peers, subordinates, and superiors in special information exchanges.

However, Monsanto's repatriation program focuses on more than just business; it also attends to the family's reentry. Monsanto has found that difficulties with repatriation often have more to do with personal and family-related issues than with work-related issues. But the personal matters obviously affect an employee's on-the-job performance, so it is important for the company to pay attention to such issues.

This is why Monsanto offers returning employees an opportunity to work through personal difficulties. About three months after they return home, expatriates meet for three hours at work with several colleagues of their choice. The debriefing session is a conversation aided by a trained facilitator who has an outline to help the expatriate cover all the important aspects of the repatriation. The debriefing allows the employee to share important experiences and to enlighten managers, colleagues, and friends about his or her expertise so others within the organization can use some of the global knowledge. According to one participant, "It sounds silly, but it's such a hectic time in the family's life, you don't have time to sit down and take stock of what's happening. You're going through the move, transitioning to a new job, a new house, and the children may be going to a new school. This is a kind of oasis; a time to talk and put your feelings on the table." Apparently it works; since the program was introduced, the attrition rate among returning expatriates has dropped sharply.[51]

performance-enhancing knowledge within the organization.[52] Consider the Swedish telecommunications company Ericsson. Interunit cooperation is extremely important at Ericsson, particularly for transferring know-how and core competencies from the parent to foreign subsidiaries, from foreign subsidiaries to the parent, and between foreign subsidiaries. To facilitate cooperation, Ericsson transfers large numbers of people back and forth between headquarters and subsidiaries. Ericsson sends a team of 50 to 100 engineers and managers from one unit to another for a year or two. This establishes a network of interpersonal contacts. This policy is effective for both solidifying a common culture in the company and coordinating the company's globally dispersed operations.[53]

Performance Appraisal LO5

Performance appraisal systems are used to evaluate the performance of managers against some criteria that the firm judges to be important for the implementation of strategy and the attainment of a competitive advantage. A firm's performance appraisal systems are an important element of its control systems, which is a central component of organization architecture (see Figure 19.1). A particularly thorny issue in many international

businesses is how best to evaluate the performance of expatriate managers.[54] This section looks at this issue and considers guidelines for appraising expatriate performance.

PERFORMANCE APPRAISAL PROBLEMS

Unintentional bias makes it difficult to evaluate the performance of expatriate managers objectively. In many cases, two groups evaluate the performance of expatriate managers—host-nation managers and home-office managers—and both are subject to bias. The host-nation managers may be biased by their own cultural frame of reference and expectations. For example, Oddou and Mendenhall report the case of a U.S. manager who introduced participative decision making while working in an Indian subsidiary.[55] The manager subsequently received a negative evaluation from host-country managers because in India, the strong social stratification means managers are seen as experts who should not have to ask subordinates for help. The local employees apparently viewed the U.S. manager's attempt at participatory management as an indication that he was incompetent and did not know his job.

Home-country managers' appraisals may be biased by distance and by their own lack of experience working abroad. Home-office managers are often not aware of what is going on in a foreign operation. Accordingly, they tend to rely on hard data in evaluating an expatriate's performance, such as the subunit's productivity, profitability, or market share. Such criteria may reflect factors outside the expatriate manager's control (e.g., adverse changes in exchange rates, economic downturns). Also, hard data do not take into account many less-visible soft variables that are also important, such as an expatriate's ability to develop cross-cultural awareness and to work productively with local managers. Due to such biases, many expatriate managers believe that headquarters management evaluates them unfairly and does not fully appreciate the value of their skills and experience. This could be one reason many expatriates believe a foreign posting does not benefit their careers. In one study of personnel managers in U.S. multinationals, 56 percent of the managers surveyed stated that a foreign assignment is either detrimental or immaterial to one's career.[56]

GUIDELINES FOR PERFORMANCE APPRAISAL

Several things can reduce bias in the performance appraisal process.[57] First, most expatriates appear to believe more weight should be given to an on-site manager's appraisal than to an off-site manager's appraisal. Due to proximity, an on-site manager is more likely to evaluate the soft variables that are important aspects of an expatriate's performance. The evaluation may be especially valid when the on-site manager is of the same nationality as the expatriate, since cultural bias should be alleviated. In practice, home-office managers often write performance evaluations after receiving input from on-site managers. When this is the case, most experts recommend that a former expatriate who served in the same location should be involved in the appraisal to help reduce bias. Finally, when the policy is for foreign on-site managers to write performance evaluations, home-office managers should be consulted before an on-site manager completes a formal termination evaluation. This gives the home-office manager the opportunity to balance what could be a very hostile evaluation based on a cultural misunderstanding.

LO6 Compensation

Two issues are raised in every discussion of compensation practices in an international business. One is how compensation should be adjusted to reflect national differences in economic circumstances and compensation practices. The other issue is how expatriate managers should be paid. From a strategic perspective, the important point is that whatever compensation system is used, it should reward managers for taking actions that are consistent with the strategy of the enterprise.

NATIONAL DIFFERENCES IN COMPENSATION

Substantial differences exist in the compensation of executives at the same level in various countries. The results of a survey undertaken by Towers Perrin are summarized in Table 19.3. Among other things, this survey looked at average compensation for top human resource executives across 26 countries in the 2005–2006 period for companies with annual sales of about $500 million.[58] The figures include both base compensation and performance-related pay bonuses, but they do not include stock options. As can be seen, wide variations exist across countries. The average compensation for a top HR executive in the United States was $525,923, compared with $278,697 in Japan and $158,146 in Taiwan. According to Towers Perrin, similar pay differences can be seen across other job categories, including the CEO and CFO positions. These figures underestimate the true differential because many U.S. executives earn considerable sums of money from stock option grants.

TABLE 19.3

Compensation in 26 Countries for Top Human Resource Executives

Country	HR Executive Total Compensation ($)
Argentina	212,879
Australia	293,782
Belgium	446,624
Brazil	356,733
Canada	307,053
China (Hong Kong)	268,158
China (Shanghai)	85,393
France	384,904
Germany	456,665
India	146,384
Italy	432,569
Japan	278,697
Malaysia	140,587
Mexico	382,334
Netherlands	287,247
Poland	120,410
Singapore	230,281
South Africa	371,781
South Korea	182,716
Spain	305,519
Sweden	302,473
Switzerland	447,563
Taiwan	158,146
United Kingdom	494,519
United States	525,923
Venezuela	225,317

Source: Towers Perrin, *Towers Perrin Worldwide Total Remuneration Study, 2005–2006*, www.towersperrin.com.



MANAGEMENT FOCUS

Global Compensation Practices at McDonald's

With more than 400,000 managers and senior staff employees in 118 countries around the world, by the early 2000s McDonald's realized it had to develop a consistent global compensation and performance appraisal strategy. After months of consultation with managers all over the world, in 2004 the company began to roll out its new global compensation program.

One important element of this program calls for the corporate head office to provide local country managers with a menu of business principles to focus on in the coming year. These principles include areas such as customer service, marketing, and restaurant re-imaging. Each country manager then picks three to five areas to focus on for success in the local market. For example, if France is introducing a new menu item, it might create business targets around that for the year. Human resource managers then submit their business cases and targets to senior executives at headquarters for approval. At the end of the year, the country's annual incentive pool is based on how the region met its targets, as well as on the business unit's operating income. A portion of an individual employee's annual bonus is based upon that mix.

The other portion of an employee's annual incentive is based on individual performance. McDonald's has always had a performance rating system, but in 2004 the company introduced global guidelines that suggest 20 percent of employees receive the highest rating, 70 percent the middle, and 10 percent the bottom. By giving guidelines rather than forced ranking, McDonald's hopes to encourage differentiation of performance while allowing for some local flexibility nuances. By providing principles and guidance, and yet allowing local managers to customize their compensation programs to meet local market demands, McDonald's also claims it has seen a reduction in turnover. The company's own internal surveys suggest more employees now believe that their compensation is fair and reflects local market conditions.[59]

National differences in compensation raise a perplexing question for an international business: Should the firm pay executives in different countries according to the prevailing standards in each country, or should it equalize pay on a global basis? The problem does not arise in firms pursuing ethnocentric or polycentric staffing policies. In ethnocentric firms, the issue can be reduced to that of how much home-country expatriates should be paid (which we will consider later). As for polycentric firms, the lack of managers' mobility among national operations implies that pay can and should be kept country-specific. There would seem to be no point in paying executives in Great Britain the same as U.S. executives if they never work side by side.

However, this problem is very real in firms with geocentric staffing policies. A geocentric staffing policy is consistent with a transnational strategy. One aspect of this policy is the need for a cadre of international managers that may include many different nationalities. Should all members of such a cadre be paid the same salary and the same incentive pay? For a U.S.-based firm, this would mean raising the compensation of foreign nationals to U.S. levels, which could be expensive. If the firm does not equalize pay, it could cause considerable resentment among foreign nationals who are members of the international cadre and work with U.S. nationals. If a firm is serious about building an international cadre, it may have to pay its international executives the same basic salary irrespective of their country of origin or assignment. Currently, however, this practice is not widespread.

Over the past 10 years many firms have moved toward a compensation structure that is based upon consistent global standards, with employees being evaluated by the same grading system and having access to the same bonus pay and benefits structure irrespective of where they work. Some 85 percent of the companies in a survey by Mercer Management Consulting stated they now have a global compensation strategy in place.[60] McDonald's, which is featured in the accompanying Management Focus, is one such

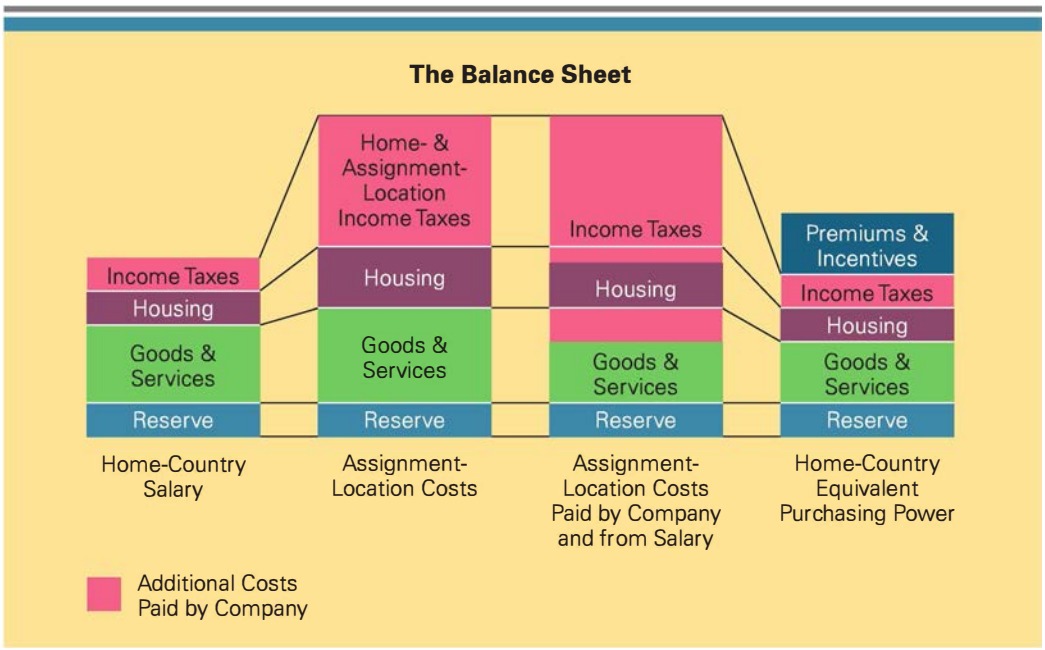

FIGURE 19.2

The Balance Sheet Approach to Expatriate Pay

enterprise. Another survey found that two-thirds of multinationals now exercise central control over the benefit plans offered in different nations.[61] However, except for a relative small cadre of internationally mobile executives, base pay in most firms is set with regard to local market conditions.

EXPATRIATE PAY

The most common approach to expatriate pay is the balance sheet approach. According to Organizational Resources Consulting, some 80 percent of the 781 companies it surveyed used this approach.[62] This approach equalizes purchasing power across countries so employees can enjoy the same living standard in their foreign posting that they enjoyed at home. In addition, the approach provides financial incentives to offset qualitative differences between assignment locations.[63] Figure 19.2 shows a typical balance sheet. Note that home-country outlays for the employee are designated as income taxes, housing expenses, expenditures for goods and services (food, clothing, entertainment, etc.), and reserves (savings, pension contributions, etc.). The balance sheet approach attempts to provide expatriates with the same standard of living in their host countries as they enjoy at home plus a financial inducement (i.e., premium, incentive) for accepting an overseas assignment.

The components of the typical expatriate compensation package are a base salary, a foreign service premium, allowances of various types, tax differentials, and benefits. We shall briefly review each of these components.[64] An expatriate's total compensation package may amount to three times what he or she would cost the firm in a home-country posting. Because of the high cost of expatriates, many firms have reduced their use of them in recent years. However, a firm's ability to reduce its use of expatriates may be limited, particularly if it is pursuing an ethnocentric or geocentric staffing policy.

Base Salary

An expatriate's base salary is normally in the same range as the base salary for a similar position in the home country. The base salary is normally paid in either the home-country currency or in the local currency.

Foreign Service Premium

A foreign service premium is extra pay the expatriate receives for working outside his or her country of origin. It is offered as an inducement to accept foreign postings. It compensates the expatriate for having to live in an unfamiliar country isolated from family and friends, having to deal with a new culture and language, and having to adapt to new work habits and practices. Many firms pay foreign service premiums as a percentage of base salary, ranging from 10 to 30 percent after tax, with 16 percent being the average premium.[65]

Allowances

Four types of allowances are often included in an expatriate's compensation package: hardship allowances, housing allowances, cost-of-living allowances, and education allowances. A hardship allowance is paid when the expatriate is being sent to a difficult location, usually defined as one where such basic amenities as health care, schools, and retail stores are grossly deficient by the standards of the expatriate's home country. A housing allowance is normally given to ensure that the expatriate can afford the same quality of housing in the foreign country as at home. In locations where housing is expensive (e.g., London, Tokyo), this allowance can be substantial—as much as 10 to 30 percent of the expatriate's total compensation package. A cost-of-living allowance ensures that the expatriate will enjoy the same standard of living in the foreign posting as at home. An education allowance ensures that an expatriate's children receive adequate schooling (by home-country standards). Host-country public schools are sometimes not suitable for an expatriate's children, in which case they must attend a private school.

Taxation

Unless a host country has a reciprocal tax treaty with the expatriate's home country, the expatriate may have to pay income tax to both the home- and host-country governments. When a reciprocal tax treaty is not in force, the firm typically pays the expatriate's income tax in the host country. In addition, firms normally make up the difference when a higher income tax rate in a host country reduces an expatriate's take-home pay.

Benefits

Many firms also ensure that their expatriates receive the same level of medical and pension benefits abroad that they received at home. This can be costly for the firm, since many benefits that are tax deductible for the firm in the home country (e.g., medical and pension benefits) may not be deductible out of the country.

LO7 International Labor Relations

The HRM function of an international business is typically responsible for international labor relations. From a strategic perspective, the key issue in international labor relations is the degree to which organized labor can limit the choices of an international business. A firm's ability to integrate and consolidate its global operations to realize experience curve and location economies can be limited by organized labor, constraining the pursuit of a transnational or global standardization strategy. Prahalad and Doz cite the example of General Motors, which gained peace with labor unions by agreeing not to integrate and consolidate operations in the most efficient manner.[66] General Motors made substantial investments in Germany—matching its new investments in Austria and Spain—at the demand of the German metalworkers' unions.

One task of the HRM function is to foster harmony and minimize conflict between the firm and organized labor. With this in mind, this section is divided into three parts. First, we review organized labor's concerns about multinational enterprises. Second, we

look at how organized labor has tried to deal with these concerns. And third, we look at how international businesses manage their labor relations to minimize labor disputes.

THE CONCERNS OF ORGANIZED LABOR

Labor unions generally try to get better pay, greater job security, and better working conditions for their members through collective bargaining with management. Unions' bargaining power is derived largely from their ability to threaten to disrupt production, either by a strike or some other form of work protest (e.g., refusing to work overtime). This threat is credible, however, only insofar as management has no alternative but to employ union labor.

A principal concern of domestic unions about multinational firms is that the company can counter its bargaining power with the power to move production to another country. Ford, for example, clearly threatened British unions with a plan to move manufacturing to Continental Europe unless British workers abandoned work rules that limited productivity, showed restraint in negotiating for wage increases, and curtailed strikes and other work disruptions.[67]

Another concern of organized labor is that an international business will keep highly skilled tasks in its home country and farm out only low-skilled tasks to foreign plants. Such a practice makes it relatively easy for an international business to switch production from one location to another as economic conditions warrant. Consequently, the bargaining power of organized labor is once more reduced.

A final union concern arises when an international business attempts to import employment practices and contractual agreements from its home country. When these practices are alien to the host country, organized labor fears the change will reduce its influence and power. This concern has surfaced in response to Japanese multinationals that have been trying to export their style of labor relations to other countries. For example, much to the annoyance of the United Auto Workers (UAW), many Japanese auto plants in the United States are not unionized. As a result, union influence in the auto industry is declining.

THE STRATEGY OF ORGANIZED LABOR

Organized labor has responded to the increased bargaining power of multinational corporations by taking three actions: (1) trying to establish international labor organizations, (2) lobbying for national legislation to restrict multinationals, and (3) trying to achieve international regulations on multinationals through such organizations as the United Nations. These efforts have not been very successful.

In the 1960s, organized labor began to establish international trade secretariats (ITSs) to provide worldwide links for national unions in particular industries. The long-term goal was to be able to bargain transnationally with multinational firms. Organized labor believed that by coordinating union action across countries through an ITS, it could counter the power of a multinational corporation by threatening to disrupt production on an international scale. For example, Ford's threat to move production from Great Britain to other European locations would not have been credible if the unions in various European countries had united to oppose it.

However, the ITSs have had virtually no real success. Although national unions may want to cooperate, they also compete with each other to attract investment from international businesses, and hence jobs for their members. For example, in attempting to gain new jobs for their members, national unions in the auto industry often court auto firms that are seeking locations for new plants. One reason Nissan chose to build its European production facilities in Great Britain rather than Spain was that the British unions agreed to greater concessions than the Spanish unions did. As a result of such competition between national unions, cooperation is difficult to establish.

A further impediment to cooperation has been the wide variation in union structure. Trade unions developed independently in each country. As a result, the structure and ideology of unions tend to vary significantly from country to country, as does the nature of collective bargaining. For example, in Great Britain, France, and Italy, many unions are controlled by left-wing socialists, who view collective bargaining through the lens of "class conflict." In contrast, most union leaders in Germany, the Netherlands, Scandinavia, and Switzerland are far more moderate politically. The ideological gap between union leaders in different countries has made cooperation difficult. Divergent ideologies are reflected in radically different views about the role of a union in society and the stance unions should take toward multinationals.

Organized labor has also met with only limited success in its efforts to get national and international bodies to regulate multinationals. Such international organizations as the International Labor Organization (ILO) and the Organization for Economic Cooperation and Development (OECD) have adopted codes of conduct for multinational firms to follow in labor relations. However, these guidelines are not as far-reaching as many unions would like. They also do not provide any enforcement mechanisms. Many researchers report that such guidelines are of only limited effectiveness.[68]

APPROACHES TO LABOR RELATIONS

International businesses differ markedly in their approaches to international labor relations. The main difference is the degree to which labor relations activities are centralized or decentralized. Historically, most international businesses have decentralized international labor relations activities to their foreign subsidiaries because labor laws, union power, and the nature of collective bargaining varied so much from country to country. It made sense to decentralize the labor relations function to local managers. The belief was that there was no way central management could effectively handle the complexity of simultaneously managing labor relations in a number of different environments.

Although this logic still holds, the trend is toward greater centralized control. This trend reflects international firms' attempts to rationalize their global operations. The general rise in competitive pressure in industry after industry has made it more important for firms to control their costs. Because labor costs account for such a large percentage of total costs, many firms are now using the threat to move production to another country in their negotiations with unions to change work rules and limit wage increases (as Ford did in Europe). Because such a move would involve major new investments and plant closures, this bargaining tactic requires the input of headquarters management. Thus, the level of centralized input into labor relations is increasing.

In addition, the realization is growing that the way work is organized within a plant can be a major source of competitive advantage. Much of the competitive advantage of Japanese automakers, for example, has been attributed to the use of self-managing teams, job rotation, cross-training, and the like in their Japanese plants.[69] To replicate their domestic performance in foreign plants, the Japanese firms have tried to replicate their work practices there. This often brings them into direct conflict with traditional work practices in those countries, as sanctioned by the local labor unions, so the Japanese firms have often made their foreign investments contingent on the local union accepting a radical change in work practices. To achieve this, the headquarters of many Japanese firms bargains directly with local unions to get union agreement to changes in work rules before committing to an investment. For example, before Nissan decided to invest in northern England, it got a commitment from British unions to agree to a change in traditional work practices. By its very nature, pursuing such a strategy requires centralized control over the labor relations function.

CHAPTER SUMMARY

This chapter focused on human resource management in international businesses. HRM activities include human resource strategy, staffing, performance evaluation, management development, compensation, and labor relations. None of these activities is performed in a vacuum; all must be appropriate to the firm's strategy. The chapter made the following points:

1. Firm success requires HRM policies to be congruent with the firm's strategy and with its formal and informal structure and controls.
2. Staffing policy is concerned with selecting employees who have the skills required to perform particular jobs. Staffing policy can be a tool for developing and promoting a corporate culture.
3. An ethnocentric approach to staffing policy fills all key management positions in an international business with parent-country nationals. The policy is congruent with an international strategy. A drawback is that ethnocentric staffing can result in cultural myopia.
4. A polycentric staffing policy uses host-country nationals to manage foreign subsidiaries and parent-country nationals for the key positions at corporate headquarters. This approach can minimize the dangers of cultural myopia, but it can create a gap between home- and host-country operations. The policy is best suited to a localization strategy.
5. A geocentric staffing policy seeks the best people for key jobs throughout the organization, regardless of their nationality. This approach is consistent with building a strong unifying culture and informal management network and is well suited to both global standardization and transnational strategies. Immigration policies of national governments may limit a firm's ability to pursue this policy.
6. A prominent issue in the international staffing literature is expatriate failure, defined as the premature return of an expatriate manager to his or her home country. The costs of expatriate failure can be substantial.
7. Expatriate failure can be reduced by selection procedures that screen out inappropriate candidates. The most successful expatriates seem to be those who have high self-esteem and self-confidence, can get along well with others, are willing to attempt to communicate in a foreign language, and can empathize with people of other cultures.
8. Training can lower the probability of expatriate failure. It should include cultural training, language training, and practical training, and it should be provided to both the expatriate manager and the spouse.
9. Management development programs attempt to increase the overall skill levels of managers through a mix of ongoing management education and rotation of managers through different jobs within the firm to give them varied experiences. Management development is often used as a strategic tool to build a strong unifying culture and informal management network, both of which support transnational and global standardization strategies.
10. It can be difficult to evaluate the performance of expatriate managers objectively because of unintentional bias. A firm can take a number of steps to reduce this bias.
11. Country differences in compensation practices raise a difficult question for an international business: Should the firm pay executives in different countries according to the standards in each country or equalize pay on a global basis?
12. The most common approach to expatriate pay is the balance sheet approach. This approach aims to equalize purchasing power so employees can enjoy the same living standard in their foreign posting that they had at home.
13. A key issue in international labor relations is the degree to which organized labor can limit the choices available to an international business. A firm's ability to pursue a transnational or global standardization strategy can be significantly constrained by the actions of labor unions.
14. A principal concern of organized labor is that the multinational can counter union bargaining power with threats to move production to another country.
15. Organized labor has tried to counter the bargaining power of multinationals by forming international labor organizations. In general, these efforts have not been effective.

Critical Thinking and Discussion Questions

1. What are the main advantages and disadvantages of the ethnocentric, polycentric, and geocentric approaches to staffing policy? When is each approach appropriate?
2. Research suggests that many expatriate employees encounter problems that limit both their effectiveness in a foreign posting and their contribution to the company when they return home. What are the main causes and consequences of these problems, and how might a firm reduce the occurrence of such problems?
3. What is the link between an international business's strategy and its human resource management policies, particularly with regard to the use of expatriate employees and their pay scale?
4. In what ways can organized labor constrain the strategic choices of an international business? How can an international business limit these constraints?
5. Reread the Management Focus on McDonald's global compensation practices. How does McDonald's approach help the company take local differences into account when reviewing the performance of different country managers and awarding bonus pay?

Research Task globalEDGE globaledge.msu.edu

Global Human Resource Management

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The impact of strikes and lockouts on business activities can be substantial. Since your company is planning to develop operations in the Asian market, you have been tasked with identifying the countries least likely to have strikes and lockouts which could introduce instability at any future facilities. Using information from the *International Labour Organization* (ILO) to develop your report, locate the ILO's yearbook of labor statistics and identify the three Asian countries with the lowest rate of strikes and lockouts. Be sure to use the most recent data available and include details for each country concerning the sectors most impacted.

Exercise 2

You work in the human resources department at the headquarters of a multinational corporation. Your company is about to send managers overseas as expatriates (or expats) to France, Russia, Singapore, and Thailand. To evaluate the possible issues each expat may encounter, you have been advised to use the *Expat Explorer* survey conducted by HBSC and found at the company's Expat Zone. Prepare a report indicating the potential issues your department may encounter during each expat's stay in these countries.

CLOSING CASE

AstraZeneca

AstraZeneca is one of the world's largest pharmaceutical companies. Headquartered in London, the company has 65,000 employees, 51 percent of whom are in Europe, 32 percent in the Americas, and 17 percent in Asia, Africa, and Australia. The company is active in more than 100 nations and has sales in excess of $30 billion. A key strategic imperative for this multinational is to build a talented global workforce, led by managers who have a global perspective, are comfortable moving around the world, interacting with people from other cultures, and doing business in different nations. It is not easy.

To help build international bench strength, the company moves managers to another country for up to three years. Such assignments are not cheap; the company estimates that it can cost two to four times an employee's annual salary to cover expenses. Expenses can include a child's school tuition, tax equalization, cultural training, and subsidized housing. Because of this expense,

AstraZeneca focuses its international assignments only on its most promising "high potential" employees, those who are scheduled for advancement and leadership positions within the company. In every case, the human resource staff will assess whether the investment in a person is worth making. Simply posting an employee to a foreign country is not enough. To get promoted, employees must also learn to work in international teams and to manage across borders. If a person is judged to lack the capability to do this, he or she will not get a foreign posting. If the employee fails to do this effectively when on the posting, advancement prospects will be reduced.

To ease the transition to another country, AstraZeneca offers employees and their spouses help with moving, locating schools for children, learning a language, and understanding cultural differences. The company also offers repatriation training for employees coming home after extended postings abroad. It does this because experience has shown that many expatriates and their families have problems readjusting to their old life after extended time in a different culture.

Another problem that the human resource function at AstraZeneca has to grapple with is how to raise the talent base of employees in emerging markets where AstraZeneca has been making big investments in recent years. An example is China, where until recently, there was very little in the way of professional management education (this is now changing rapidly). In 2003 the company had a little more than 1,000 employees in China. Now it has over 3,500. AstraZeneca has been trying to raise the skill level of key Chinese employees as fast as possible. With regard to key managerial talent, the company has been sending them abroad to get exposure to other cultures and to acculturate them into the way in which AstraZeneca does business. It wants them to understand what it is like to be part of a global business. Each expatriate will have a host-country line manager assigned to him or her, as well as a home-country line manager who monitors the expatriate's progress. After a period, the majority of them return to China where the most successful are targeted for future leadership positions within the Chinese subsidiary. The most talented, however, may go beyond this, and ultimately move into senior management positions at the corporate level.[70]

Case Discussion Questions

1. What international staffing policy is AstraZeneca pursuing with regard to its "high potential" employees?
2. Why does AstraZeneca limit this policy to just high potential employees? Can you see a drawback in doing this?
3. What staffing policy is AstraZeneca adopting with regard to its subsidiaries in places such as China? Is this an appropriate policy?
4. Do you think the company is doing enough to limit the well-known risks and costs associated with high expatriate failure rates? Is there anything else it might do?

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20 Accounting and Finance in the International Business

LEARNING OBJECTIVES

After reading this chapter you will be able to:

- **LO1** Discuss the national differences in accounting standards.
- **LO2** Explain the implications of the rise of international accounting standards.
- **LO3** Explain how accounting systems affect control systems within the multinational enterprise.
- **LO4** Discuss how operating in different nations impacts investment decisions within the multinational enterprise.
- **LO5** Discuss the different financing options available to the foreign subsidiary of a multinational enterprise.
- **LO6** Understand how money management in the international business can be used to minimize cash balances, transaction costs, and taxation.
- **LO7** Understand the basic techniques for global money management.

Chinese Accounting

Over the past decade, more and more Chinese companies have been tapping global capital markets and more foreigners have been investing in Chinese companies through the Shanghai stock exchange. Foreign investors want to be assured that the financial picture they are getting of Chinese enterprises is reliable. That has not always been the case. In December 2003, for example, China Life Insurance successfully listed its stock on the Hong Kong and New York stock exchanges, raising some $3.4 billion. However, in January 2004, the head of China's National Audit Office let it slip that a routine audit of China Life's state-owned parent company had uncovered $652 million in financial irregularities in 2003. The stock immediately fell, and China Life found itself the target of a class action lawsuit on behalf of U.S. investors claiming financial fraud. Soon afterward, plans to list China Minsheng Banking Corp., China's largest private bank, on the New York Stock Exchange were put on hold after the company admitted it had faked a shareholder meeting in 2000. The stock of another successful Chinese offering in New York, Semiconductor Manufacturing International, slid in 2004 when its chief financial officer made statements that contradicted those contained in filings with the U.S. Securities and Exchange Commission.

The core of the problem is that accounting rules in China are not consistent with international standards, making it difficult for investors to accurately value Chinese companies. Accounting in China has traditionally been rooted in information gathering and compliance reporting designed to measure the government's production and tax goals. The Chinese system was based on



the old Soviet system, which had little to do with profit. Although the system has changing rapidly, many problems associated with the old order still remained. Indeed, it is often said, only half in jest, that Chinese firms keep several sets of books—one for the government, one for company records, one for foreigners, and one to report what is actually going on.

To bring its rules into closer alignment with international standards, China has signaled that it will move toward adopting standards developed by the International Accounting Standards Board (IASB). In 2001, China adopted a new regulation, called the Accounting System for Business Enterprises, that was largely based on ISAB standards. The system is now used to regulate both local and foreign companies operating in China. In 2005, the Chinese went further still, mandating that on January 1, 2007, the largest 1,200 firms listed on the Shanghai and Shenzhen exchanges adopt a broad set of accounting rules that are based on, but not identical to, IASB standards. It remains to be seen whether adoption of these new rules will make the financial performance of Chinese companies more transparent.

At present, many large public Chinese companies are now reporting results according to two sets of rules, Chinese accounting standards and IASB standards. The differences between the two are instructive. In mid-2008 China Eastern, one of the largest airlines in China, said its net profit fell 29 percent from a year earlier to 41.6 million yuan ($6.1 million) under Chinese accounting rules. Based on international standards, however, the airline incurred a net loss of 212.5 million yuan, over five times as great![1]

Introduction

This chapter deals with two related topics, accounting and finance in the international business. These are both highly specialized topics, and a full review is beyond the scope of an introductory textbook. The goal of this chapter is to provide the reader with a high-level nontechnical overview of some of the main issues in accounting and finance that confront the manager in an international business.

Accounting has often been referred to as "the language of business."[2] This language finds expression in profit-and-loss statements, balance sheets, budgets, investment analysis, and tax analysis. Accounting information is the means by which firms communicate their financial position to the providers of capital, enabling them to assess the value of their investments and make decisions about future resource allocations. Accounting information is also the means by which firms report their income to the government, so the government can assess how much tax the firm owes. It is also the means by which the firm can evaluate its performance, control its internal expenditures, and plan for future expenditures and income. Thus, a good accounting function is critical to the smooth running of the firm, and to a nation's financial system.

International businesses face a number of accounting problems that do not confront purely domestic businesses. The opening case on accounting in China draws attention to one of these problems—the lack of consistency in the accounting standards of different countries. The accounting rules currently used in China are not the same as those used in more developed markets (although as the case explains, the Chinese are pushing companies toward adoption of international accounting standards). This makes it difficult for international investors to accurately value Chinese firms and opens up the possibility that firms that seem to be profitable, and financially strong, are in fact not.

Financial management in an international business includes three sets of related decisions: (1) investment decisions, decisions about what activities to finance, (2) financing decisions, decisions about how to finance those activities, and (3) money management decisions, decisions about how to manage the firm's financial resources most efficiently. In an international business, investment, financing, and money management decisions are complicated by the fact that countries have different currencies, different tax regimes, different regulations concerning the flow of capital across their borders, different norms regarding the financing of business activities, different levels of economic and political risk, and so on. Financial managers must consider all these factors when deciding which activities to finance, how best to finance those activities, how best to manage the firm's financial resources, and how best to protect the firm from political and economic risks (including foreign exchange risk).

This chapter begins by looking at country differences in accounting standards and current attempts aimed at harmonizing account standards across nations. Next we discuss the issues that can arise when managers in the international business use accounting systems to control foreign subsidiaries. Then we move on to look at investment decisions in an international business. We discuss how such factors as political and economic risk complicate investment decisions. This is followed by a review of financing decisions in an international business. Finally, we examine money management decisions in an international business. We will look at the objectives of global money management, the various ways businesses can move money across borders, and some techniques for managing the firm's financial resources efficiently. This chapter does not discuss policies for managing foreign exchange risk, even though they are a very important part of financial management in the international business, because Chapter 10 covered the topic when we looked at the foreign exchange market and the forces that determine exchange rate movements.

National Differences in Accounting Standards LO1

Accounting is shaped by the environment in which it operates. Just as different countries have different political systems, economic systems, and cultures, historically they have also had different accounting systems.[3] These differences had a number of sources. For example, in countries where there were well-developed capital markets, such as the United States and Britain, firms typically raised capital by issuing stock or bonds to investors. Investors in these countries demanded detailed accounting disclosures so that they could better assess the risk and likely return on their investments. The accounting system evolved to accommodate these requests. In contrast, in Germany and Switzerland the banks emerged as the main providers of capital to enterprises. Bank officers often sat on the boards of these companies and were privy to detailed information about their operations and financial position. As a consequence, there were fewer demands for detailed accounting disclosures, and public accounts tended to reveal less information. Another important influence has been the political or economic ties between nations. U.S.-style accounting systems were adopted in the Philippines, which was once a U.S. protectorate. Similarly, the vast majority of former colonies of the British Empire have accounting practices modeled after Great Britain's, while former French colonies followed the French system.

Diverse accounting practices were enshrined in national accounting and auditing standards. **Accounting standards** are rules for preparing financial statements; they define what is useful accounting information. **Auditing standards** specify the rules for performing an audit—the technical process by which an independent person (the auditor) gathers evidence for determining if financial accounts conform to required accounting standards and if they are also reliable.

One result of national differences in accounting and auditing standards was a general lack of comparability of financial reports from one country to another (something that is now changing). For example: (1) Dutch standards favored the use of current values for replacement assets; Japanese law generally prohibited revaluation and prescribes historic cost; (2) capitalization of financial leases was required practice in Great Britain, but not practiced in France; (3) research and development costs must be written off in the year they are incurred in the United States, but in Spain they could be deferred as an asset and need not be amortized as long as benefits that will cover them are expected to arise in the future; (4) German accountants treated depreciation as a liability, whereas British companies deducted it from assets.

Such differences would not matter much if there were little need for a firm headquartered in one country to report its financial results to citizens of another country. However, one striking development of the past two decades has been the development of global capital markets. We have seen the growth of both transnational financing and transnational investment. Transnational financing occurs when a firm based in one country enters another country's capital market to raise capital from the sale of stocks or bonds. Transnational investment occurs when an investor based in one country enters the capital market of another nation to invest in the stocks or bonds of a firm based in that country.

The rapid expansion of transnational financing and investment has been accompanied by a corresponding growth in transnational financial reporting. However, the lack of comparability between accounting standards in different nations caused some confusion. For example, the German firm that issued two sets of financial reports, one set prepared under German standards and the other under U.S. standards, may have found that its financial position looked significantly different in the two reports, and its investors may have difficulty identifying the firm's true worth. Some examples of the confusion that arose from this lack of comparability appear in the accompanying Management Focus.

In addition to the problems lack of comparability gives investors, it can give the firm major headaches. The firm has to explain to its investors why its financial position looks



MANAGEMENT FOCUS

The Consequences of Different Accounting Standards

In 1999, two major drug firms, Zeneca and Astra merged to form AstraZeneca. Based in the United Kingdom, in 2000 the profit of AstraZeneca was $865 million under U.S. accounting rules, but $3,318 million under British accounting rules. The largest difference between the two sets of accounts was $1,756 million related to amortization and other acquisition-related costs. Under rules then prevailing in the United States, the combination of Astra and Zeneca was treated as an acquisition, which required goodwill to be recognized with consequent amortization. Under British rules, any amortization was avoided as the combination was treated as a merger and so no goodwill arose.

U.S.-based SmithKline Beckman (SKB) merged with the British company Beecham Group in 1989. After the merger, SKB had quotations on both the London and New York stock exchanges, so it had to prepare financial reports in accordance with both U.S. and British standards. SKB's postmerger earnings, properly prepared in accordance with British accounting standards, were £130 million—quite a bit more than the £87 million reported in SKB's statement prepared in accordance with U.S. accounting standards. The difference resulted primarily from treating the merger as a pooling of assets for British purposes and as a purchase of assets for U.S. purposes. Even more confusing, the differences resulted in a shareholders' equity of £3.5 billion in the United States, but a negative £300 million in Great Britain! Not surprisingly, after these figures were released, SKB's stock was trading 17 percent lower on the London Stock Exchange than on the New York Stock Exchange.

In the mid-1980s, Telefonica, Spain's largest industrial company, was the first company in the world to float a multicountry stock offering simultaneously. In 1990, it reported net income under U.S. accounting standards of 176 billion pesetas, more than twice the 76 billion pesetas it reported under Spanish accounting standards. The difference was mainly due to an "add-back" of the incremental depreciation on assets carried at historic cost in the United States but reflecting more recent market value in the Spanish report. The effect of this difference on shareholders' equity was in the opposite direction; the equity reported in the U.S. accounts was 15 percent less than the equity reported in the Spanish accounts.

In 2000, British Airways reported a loss under British accounting rules of £21 million, but under U.S. rules, its loss was £412 million. Most of the difference could be attributed to adjustments for a number of relatively small items such as depreciation and amortization, pensions, and deferred taxation. The largest adjustment was due to a reduction in revenue reported in the U.S. accounts of £136 million. This reduced revenue was related to frequent flyer miles, which under U.S. rules have to be deferred until the miles are redeemed. Apparently, this is not the case under British rules.

A final example is more hypothetical in nature, but just as revealing. Two college professors set up a computer model to evaluate the reported net profits of an imaginary company with gross operating profits of $1.5 million. This imaginary company operated in three different countries—the United States, Britain, and Australia. The professors found that holding all else equal (such as national differences in interest rates on the firm's debt), when different accounting standards were applied the firm made a net profit of $34,600 in the United States, $260,600 in Britain, and $240,600 in Australia.[4]

so different in the two accountings. Also, an international business may find it difficult to assess the financial positions of important foreign customers, suppliers, and competitors.

LO2 International Accounting Standards

Substantial efforts have been made in recent years to harmonize accounting standards across countries.[5] The rise of global capital markets during the past two decades has added urgency to this endeavor. Today, many companies raise money from providers of capital outside their national borders. Those providers are demanding consistency in the way financial results are reported so they can make more informed investment decisions.

Also, there is a realization that the adoption of common accounting standards will facilitate the development of global capital markets because more investors will be willing to invest across borders, and the end result will be to lower the cost of capital and stimulate economic growth. It is increasingly accepted that the standardization of accounting practices across national borders is in the best interests of all participants in the world economy.

The International Accounting Standards Board (IASB) has emerged as a major proponent of standardization. The IASB was formed in March 2001 to replace the International Accounting Standards Committee (IASC), which had been established in 1973. The IASB has 15 members who are responsible for the formulation of new international financial reporting standards. To issue a new standard, 75 percent of the 15 members of the board must agree. It can be difficult to get three-quarters agreement, particularly since members come from different cultures and legal systems. To get around this problem, most IASB statements provide two acceptable alternatives. As Arthur Wyatt, former chairman of the IASB, once said, "It's not much of a standard if you have two alternatives, but it's better than having six. If you can get agreement on two alternatives, you can capture the 11 required votes and eliminate some of the less used practices."[6]

Another hindrance to the development of international accounting standards is that compliance is voluntary; the IASB has no power to enforce its standards. Despite this, support for the IASB and recognition of its standards has been growing. Increasingly, the IASB is regarded as an effective voice for defining acceptable worldwide accounting principles. Japan, for example, began requiring financial statements to be prepared on a consolidated basis after the IASB issued its initial standards on the topic, and in 2004 Japanese accounting authorities started working closely with the IASB to try to harmonize standards. Russia and China have also stated their intention to adopt emerging international standards (see the opening case). By 2011 more than 100 nations had either adopted the IASB standards or permitted their use to report financial results.

To date, the impact of the IASB standards has probably been least noticeable in the United States because most of the standards issued by the IASB have been consistent with opinions already articulated by the U.S. Financial Accounting Standards Board (FASB). The FASB writes the generally accepted accounting principles (GAAP) by which the financial statements of U.S. firms must be prepared. Nevertheless, differences between IASB and FASB standards remain, although the IASB and FASB have a goal of convergence. In April 2007 the U.S. Securities and Exchange Commission stated it was considering whether to allow U.S. public companies to use IASB standards, rather than GAAP, to report their results, a move that some believe could ultimately spell the end of GAAP.[7]

Another body that is having a substantial influence on the harmonization of accounting standards is the European Union. In accordance with its plans for closer economic and political union, the EU has mandated harmonization of the accounting principles of its member countries. The EU does this by issuing directives that the member states are obligated to incorporate into their own national laws. Because EU directives have the power of law, the EU might have a better chance of achieving harmonization than the IASB does. The EU has required that since January 1, 2005, financial accounts issued by some 7,000 publicly listed companies in the EU were to be in accordance with IASB standards. The Europeans hope that this requirement, by making it easier to compare the financial position of companies from different EU member states, will facilitate the development of a pan-European capital market and ultimately lower the cost of capital for EU firms.

Given the harmonization in the EU, and given that countries including Japan, China, and Russia have signaled that they will follow suit, there could soon be only two major accounting bodies with dominant influence on global reporting: FASB in the United States and IASB elsewhere. Under an agreement reached in 2002, these two bodies are trying to align their standards, suggesting that differences in accounting standards across countries may disappear eventually.

In a move that indicates the trend toward adoption of acceptable international accounting standards is accelerating, the IASB has developed accounting standards for firms seeking stock listings in global markets. Also, the FASB has joined forces with accounting standard setters in Canada, Mexico, and Chile to explore areas in which the four countries can harmonize their accounting standards (Canada, Mexico, and the United States are members of NAFTA, and Chile may join in the near future). The SEC has also dropped many of its objections to international standards, which could accelerate their adoption.

LO3 Accounting Aspects of Control Systems

One role of corporate headquarters in large complex enterprises is to control subunits within the organization to ensure they achieve the best possible performance. In the typical firm, the control process is annual and involves three main steps: (1) head office and subunit management jointly determine subunit goals for the coming year; (2) throughout the year, the head office monitors subunit performance against the agreed goals; (3) if a subunit fails to achieve its goals, the head office intervenes in the subunit to learn why the shortfall occurred, taking corrective action when appropriate.

The accounting function plays a critical role in this process. Most of the goals for subunits are expressed in financial terms and are embodied in the subunit's budget for the coming year. The budget is the main instrument of financial control. The budget is typically prepared by the subunit, but it must be approved by headquarters management. During the approval process, headquarters and subunit managers debate the goals that should be incorporated in the budget. One function of headquarters management is to ensure a subunit's budget contains challenging but realistic performance goals. Once a budget is agreed to, accounting information systems are used to collect data throughout the year so a subunit's performance can be evaluated against the goals contained in its budget.

In most international businesses, many of the firm's subunits are foreign subsidiaries. The performance goals for the coming year are thus set by negotiation between corporate management and the managers of foreign subsidiaries. According to one survey of control practices within multinational enterprises, the most important criterion for evaluating the performance of a foreign subsidiary is the subsidiary's actual profits compared to budgeted profits.[8] This is closely followed by a subsidiary's actual sales compared to budgeted sales and its return on investment. The same criteria were also useful in evaluating the performance of the subsidiary managers. We will discuss this point later in this section. First, however, we will examine two factors that can complicate the control process in an international business: exchange rate changes and transfer pricing practices.

EXCHANGE RATE CHANGES AND CONTROL SYSTEMS

Most international businesses require all budgets and performance data within the firm to be expressed in the "corporate currency," which is normally the home currency. Thus, the Malaysian subsidiary of a U.S. multinational would probably submit a budget prepared in U.S. dollars, rather than Malaysian ringgit, and performance data throughout the year would be reported to headquarters in U.S. dollars. This facilitates comparisons between subsidiaries in different countries, and it makes things easier for headquarters management. However, it also allows exchange rate changes during the year to introduce substantial distortions. For example, the Malaysian subsidiary may fail to achieve profit goals not because of any performance problems, but merely because of a decline in the value of the ringgit against the dollar. The opposite can occur, also, making a foreign subsidiary's performance look better than it actually is.

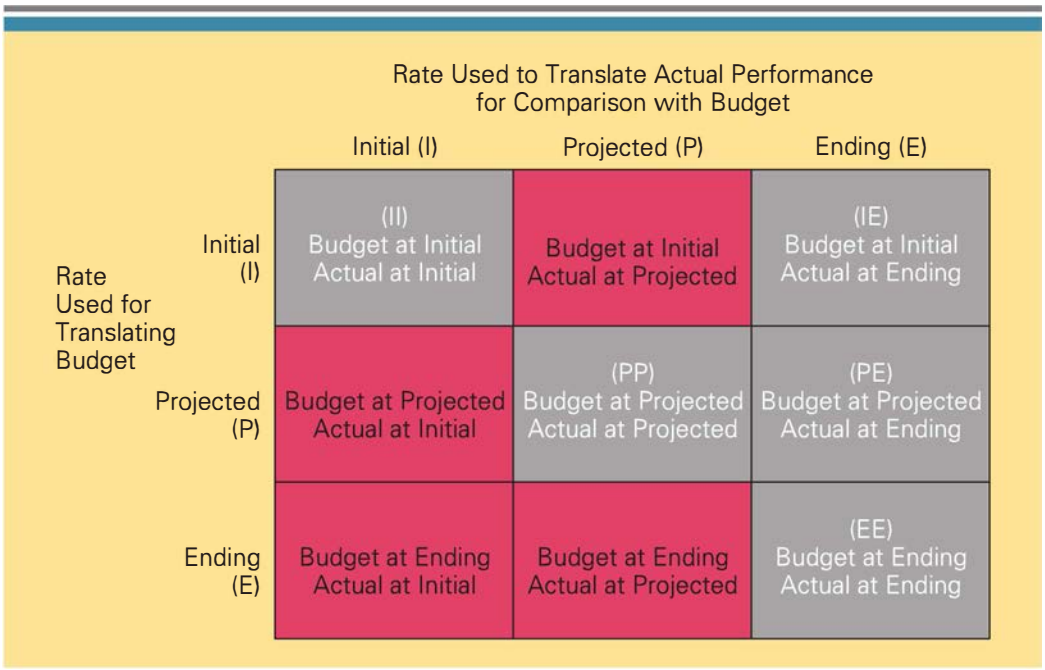


FIGURE 20.1

Possible Combinations of Exchange Rates in the Control Process

The Lessard–Lorange Model

According to research by Donald Lessard and Peter Lorange, a number of methods are available to international businesses for dealing with this problem.[9] Lessard and Lorange point out three exchange rates that can be used to translate foreign currencies into the corporate currency in setting budgets and in the subsequent tracking of performance:

- The initial rate, the spot exchange rate when the budget is adopted.
- The projected rate, the spot exchange rate forecast for the end of the budget period (i.e., the forward rate).
- The ending rate, the spot exchange rate when the budget and performance are being compared.

These three exchange rates imply nine possible combinations (see Figure 20.1). Lessard and Lorange ruled out four of the nine combinations as illogical and unreasonable; they are shaded in Figure 20.1. For example, it would make no sense to use the ending rate to translate the budget and the initial rate to translate actual performance data. Any of the remaining five combinations might be used for setting budgets and evaluating performance.

With three of these five combinations—II, PP, and EE—the same exchange rate is used for translating both budget figures and performance figures into the corporate currency. All three combinations have the advantage that a change in the exchange rate during the year does not distort the control process. This is not true for the other two combinations, IE and PE. In those cases, exchange rate changes can introduce distortions. The potential for distortion is greater with IE; the ending spot exchange rate used to evaluate performance against the budget may be quite different from the initial spot exchange rate used to translate the budget. The distortion is less serious in the case of PE because the projected exchange rate considers future exchange rate movements.

Of the five combinations, Lessard and Lorange recommend that firms use the projected spot exchange rate to translate both the budget and performance figures into the corporate currency, combination PP. The projected rate in such cases will typically be the forward exchange rate as determined by the foreign exchange market (see Chapter 10 for the definition of forward rate) or some company-generated forecast of future spot rates, which Lessard and Lorange refer to as the **internal forward rate**. The internal

forward rate may differ from the forward rate quoted by the foreign exchange market if the firm wishes to bias its business in favor of, or against, the particular foreign currency.

TRANSFER PRICING AND CONTROL SYSTEMS

Chapter 13 reviewed the various strategies that international businesses pursue. Two of these strategies, the global strategy and the transnational strategy, give rise to a globally dispersed web of productive activities. Firms pursuing these strategies disperse each value creation activity to its optimal location in the world. Thus, a product might be designed in one country, some of its components manufactured in a second country, other components manufactured in a third country, all assembled in a fourth country, and then sold worldwide.

The volume of intrafirm transactions in such firms is very high. The firms are continually shipping component parts and finished goods between subsidiaries in different countries. This poses a very important question: How should goods and services transferred between subsidiary companies in a multinational firm be priced? The price at which such goods and services are transferred is referred to as the transfer price.

The choice of transfer price can critically affect the performance of two subsidiaries that exchange goods or services. Consider this example: A French manufacturing subsidiary of a U.S. multinational imports a major component from Brazil. It incorporates this part into a product that it sells in France for the equivalent of $230 per unit. The product costs $200 to manufacture, of which $100 goes to the Brazilian subsidiary to pay for the component part. The remaining $100 covers costs incurred in France. Thus, the French subsidiary earns $30 profit per unit.

	Before Change in Transfer Price	After 20 Percent Increase in Transfer Price
Revenues per unit	$230	$230
Cost of component per unit	100	120
Other costs per unit	100	100
Profit per unit	$ 30	$ 10

See what happens if corporate headquarters decides to increase transfer prices by 20 percent ($20 per unit). The French subsidiary's profits will fall by two-thirds from $30 per unit to $10 per unit. Thus, the performance of the French subsidiary depends on the transfer price for the component part imported from Brazil, and the transfer price is controlled by corporate headquarters. When setting budgets and reviewing a subsidiary's performance, corporate headquarters must keep in mind the distorting effect of transfer prices.

How should transfer prices be determined? We discuss this issue in detail later in the chapter. International businesses often manipulate transfer prices to minimize their worldwide tax liability, minimize import duties, and avoid government restrictions on capital flows. For now, however, it is enough to note that the transfer price must be considered when setting budgets and evaluating a subsidiary's performance.

SEPARATION OF SUBSIDIARY AND MANAGER PERFORMANCE

In many international businesses, the same quantitative criteria are used to assess the performance of both a foreign subsidiary and its managers. Many accountants, however, argue that although it is legitimate to compare subsidiaries against each other on the

basis of return on investment (ROI) or other indicators of profitability, it may not be appropriate to use these for comparing and evaluating the managers of different subsidiaries. Foreign subsidiaries do not operate in uniform environments; their environments have widely different economic, political, and social conditions, all of which influence the costs of doing business in a country and hence the subsidiaries' profitability. Thus, the manager of a subsidiary in an adverse environment that has an ROI of 5 percent may be doing a better job than the manager of a subsidiary in a benign environment that has an ROI of 20 percent. Although the firm might want to pull out of a country where its ROI is only 5 percent, it may also want to recognize the manager's achievement.

Accordingly, it has been suggested that the evaluation of a subsidiary should be kept separate from the evaluation of its manager.[10] The manager's evaluation should consider how hostile or benign the country's environment is for that business. Further, managers should be evaluated in local currency terms after making allowances for those items over which they have no control (e.g., interest rates, tax rates, inflation rates, transfer prices, exchange rates).

Financial Management: The Investment Decision

LO4

One role of the financial manager in an international business is to try to quantify the various benefits, costs, and risks that are likely to flow from an investment in a given location. A decision to invest in activities in a given country must consider many economic, political, cultural, and strategic variables. We have been discussing this issue throughout much of this book. Chapters 2, 3, and 4 touched on it when we discussed how the political, economic, legal, and cultural environment of a country can influence the benefits, costs, and risks of doing business there and thus its attractiveness as an investment site. We returned to the issue in Chapter 8 with a discussion of the economic theory of foreign direct investment. We identified a number of factors that determine the economic attractiveness of a foreign investment opportunity. We also looked at the political economy of foreign direct investment in Chapter 8 and we considered the role that government intervention can play in foreign investment. In Chapter 13, we pulled much of this material together when we considered how a firm can reduce its costs of value creation and/or increase its value added by investing in productive activities in other countries. We returned to the issue again in Chapter 15 when we considered the various modes for entering foreign markets.

CAPITAL BUDGETING

Capital budgeting is the technique financial managers use to try to quantify the benefits, costs, and risks of an investment. This enables top managers to compare, in a reasonably objective fashion, different investment alternatives within and across countries so they can make informed choices about where the firm should invest its scarce financial resources. Capital budgeting for a foreign project uses the same theoretical framework that domestic capital budgeting uses; that is, the firm must first estimate the cash flows associated with the project over time. In most cases, the cash flows will be negative at first, because the firm will be investing heavily in production facilities. After some initial period, however, the cash flows will become positive as investment costs decline and revenues grow. Once the cash flows have been estimated, they must be discounted to determine their net present value using an appropriate discount rate. The most commonly used discount rate is either the firm's cost of capital or some other required rate of return. If the net present value of the discounted cash flows is greater than zero, the firm should go ahead with the project.[11]

Although this might sound quite straightforward, capital budgeting is in practice a very complex and imperfect process. Among the factors complicating the process for an international business are these:

1. A distinction must be made between cash flows to the project and cash flows to the parent company.
2. Political and economic risks, including foreign exchange risk, can significantly change the value of a foreign investment.
3. The connection between cash flows to the parent and the source of financing must be recognized.

We look at the first two of these issues in this section. Discussion of the connection between cash flows and the source of financing is postponed until the next section, where we discuss the source of financing.

PROJECT AND PARENT CASH FLOWS

A theoretical argument exists for analyzing any foreign project from the perspective of the parent company because cash flows to the project are not necessarily the same thing as cash flows to the parent company. The project may not be able to remit all its cash flows to the parent for a number of reasons. For example, cash flows may be blocked from repatriation by the host-country government, they may be taxed at an unfavorable rate, or the host government may require that a certain percentage of the cash flows generated from the project be reinvested within the host nation. While these restrictions don't affect the net present value of the project itself, they do affect the net present value of the project to the parent company because they limit the cash flows that can be remitted to it from the project.

When evaluating a foreign investment opportunity, the parent should be interested in the cash flows it will receive—as opposed to those the project generates—because those are the basis for dividends to stockholders, investments elsewhere in the world, repayment of worldwide corporate debt, and so on. Stockholders will not perceive blocked earnings as contributing to the value of the firm, and creditors will not count them when calculating the parent's ability to service its debt.

But the problem of blocked earnings is not as serious as it once was. The worldwide move toward greater acceptance of free market economics (discussed in Chapter 2 and 3) has reduced the number of countries in which governments are likely to prohibit the affiliates of foreign multinationals from remitting cash flows to their parent companies. In addition, as we will see later in the chapter, firms have a number of options for circumventing host-government attempts to block the free flow of funds from an affiliate.

ADJUSTING FOR POLITICAL AND ECONOMIC RISK

When analyzing a foreign investment opportunity, the company must consider the political and economic risks that stem from the foreign location.[12] We will discuss these before looking at how capital budgeting methods can be adjusted to take risks into account.

Political Risk

The concept of political risk was introduced in Chapter 2. There we defined it as the likelihood that political forces will cause drastic changes in a country's business environment that hurt the profit and other goals of a business enterprise. Political risk tends to be greater in countries experiencing social unrest or disorder and countries where the underlying nature of the society makes the likelihood of social unrest high. When political risk is high, there is a high probability that a change will occur in the country's political environment that will endanger foreign firms there.

MANAGEMENT FOCUS

Black Sea Energy Ltd.

In 1996, Black Sea Energy, Ltd., of Calgary, Canada, formed a 50-50 joint venture with the Tyumen Oil Company, then Russia's sixth-largest integrated oil company. The objective of the venture, know as the Tura Petroleum Company, was to explore the Tura oil field in western Siberia. At the time, Tyumen was 90 percent owned by the Russian government; consequently Black Sea Ltd. negotiated directly with representatives of the Russian government when establishing the joint venture. The agreement called for both parties to contribute more than $40 million to the formation of the venture, Black Sea in the form of cash, technology, and expertise, and Tyumen in the form of infrastructure and the licenses for oil exploration and production that it held in the region.

From an operational perspective, the venture proved to be a success. Following the injection of cash and technology from Black Sea Energy, production at the Tura field went from 4,000 barrels a day to nearly 12,000. However, Black Sea did not capture any of the economic profits flowing from this investment. In 1997, the Moscow-based Alfa Group, one of Russia's largest private companies, purchased a controlling stake in Tyumen from the Russian government. The new owners of Tyumen quickly concluded the Tura joint venture was not fair to them and they wanted it canceled. Their argument was that the value of the assets contributed by Tyumen to the joint venture was far in excess of $40 million, while the value of the technology and expertise contributed by Black Sea was significantly less than $40 million. The new owners also found some conflicting legislation that seemed to indicate the licenses held by Tura were owned by Tyumen, and that Black Sea therefore had no right to the resulting production. Tyumen took the issue to court in Russia and consistently won, despite that fact that the original deal had been negotiated by the Russian government. Black Sea Energy had little choice but to walk away from the deal. According to Black Sea, by legal maneuvering, Tyumen expropriated Black Sea's investment in the Tura venture. In contrast, the management of Tyumen claimed it had behaved in a perfectly legal manner.[13]

In extreme cases, political change may result in the expropriation of foreign firms' assets. This occurred to U.S. firms after the Iranian revolution of 1979. In recent decades, the risk of outright expropriations has become almost zero. However, a lack of consistent legislation and proper law enforcement and no willingness on the part of the government to enforce contracts and protect private property rights can result in the de facto expropriation of the assets of a foreign multinational. An example of this, which occurred in Russia, is given in the accompanying Management Focus.

Political and social unrest may also result in economic collapse, which can render worthless a firm's assets. In less extreme cases, political changes may result in increased tax rates, the imposition of exchange controls that limit or block a subsidiary's ability to remit earnings to its parent company, the imposition of price controls, and government interference in existing contracts. The likelihood of any of these events impairs the attractiveness of a foreign investment opportunity.

Many firms devote considerable attention to political risk analysis and to quantifying political risk. *Euromoney* magazine publishes an annual "country risk rating," which incorporates assessments of political and other risks and is widely used by businesses. The problem with all attempts to forecast political risk, however, is that they try to predict a future that can only be guessed at—and in many cases, the guesses are wrong. Few people foresaw the 1979 Iranian revolution, the collapse of communism in Eastern Europe, the dramatic breakup of the Soviet Union, the terrorist attack on the World Trade Center in September 2001; yet all these events had a profound impact on the business environments of many countries. This is not to say that political risk assessment is without value, but it is more art than science.

Economic Risk

The concept of economic risk also was introduced in Chapter 2. It was defined as the likelihood that economic mismanagement will cause drastic changes in a country's business environment that hurt the profit and other goals of a business enterprise. In practice, the biggest problem arising from economic mismanagement has been inflation. Historically, many governments have expanded their domestic money supply in misguided attempts to stimulate economic activity. The result has often been too much money chasing too few goods, resulting in price inflation. As we saw in Chapter 10, price inflation is reflected in a drop in the value of a country's currency on the foreign exchange market. This can be a serious problem for a foreign firm with assets in that country because the value of the cash flows it receives from those assets will fall as the country's currency depreciates on the foreign exchange market. The likelihood of this occurring decreases the attractiveness of foreign investment in that country.

There have been many attempts to quantify countries' economic risk and long-term movements in their exchange rates. (*Euromoney*'s annual country risk rating also incorporates an assessment of economic risk in its calculation of each country's overall level of risk.) As we saw in Chapter 11, there have been extensive empirical studies of the relationship between countries' inflation rates and their currencies' exchange rates. These studies show there is a long-run relationship between a country's relative inflation rates and changes in exchange rates. However, the relationship is not as close as theory would predict; it is not reliable in the short run and is not totally reliable in the long run. So, as with political risk, any attempts to quantify economic risk must be tempered with some healthy skepticism.

RISK AND CAPITAL BUDGETING

In analyzing a foreign investment opportunity, the additional risk that stems from its location can be handled in at least two ways. The first method is to treat all risk as a single problem by increasing the discount rate applicable to foreign projects in countries where political and economic risks are perceived as high. Thus, for example, a firm might apply a 6 percent discount rate to potential investments in Great Britain, the United States, and Germany, reflecting those countries' economic and political stability, and it might use a 12 percent discount rate for potential investments in Russia, reflecting the greater perceived political and economic risks in that country. The higher the discount rate, the higher the projected net cash flows must be for an investment to have a positive net present value.

Adjusting discount rates to reflect a location's riskiness seems to be fairly widely practiced. For example, several studies of large U.S, multinationals have found that many of them routinely add a premium percentage for risk to the discount rate they used in evaluating potential foreign investment projects.[14] However, critics of this method argue that it penalizes early cash flows too heavily and does not penalize distant cash flows enough.[15] They point out that if political or economic collapse were expected in the near future, the investment would not occur anyway. So for any investment decisions, the political and economic risk being assessed is not of immediate possibilities, but rather at some distance in the future. Accordingly, it can be argued that rather than using a higher discount rate to evaluate such risky projects, which penalizes early cash flows too heavily, it is better to revise future cash flows from the project downward to reflect the possibility of adverse political or economic changes sometime in the future. Surveys of actual practice within multinationals suggest that the practice of revising future cash flows downward is almost as popular as that of revising the discount rate upward.[16]

LO5 Financial Management: The Financing Decision

When considering its options for financing, an international business must consider how the foreign investment will be financed. If external financing is required, the firm must decide whether to tap the global capital market for funds or borrow from sources in the

host country. If the firm is going to seek external financing for a project, it will want to borrow funds from the lowest-cost source of capital available. As we saw in Chapter 12, firms increasingly are turning to the global capital market to finance their investments. The cost of capital is typically lower in the global capital market, by virtue of its size and liquidity, than in many domestic capital markets, particularly those that are small and relatively illiquid. Thus, for example, a U.S. firm making an investment in Denmark may finance the investment by borrowing through the London-based Eurobond market rather than the Danish capital market.

However, despite the trends toward deregulation of financial services, in some cases host-country government restrictions may rule out this option. The governments of some countries require, or at least prefer, foreign multinationals to finance projects in their country by local debt financing or local sales of equity. In countries where liquidity is limited, this raises the cost of capital used to finance a project. Thus, in capital budgeting decisions, the discount rate must be adjusted upward to reflect this. However, this is not the only possibility. In Chapter 7, we saw that some governments court foreign investment by offering foreign firms low-interest loans, lowering the cost of capital. Accordingly, in capital budgeting decisions, the discount rate should be revised downward in such cases.

In addition to the impact of host-government policies on the cost of capital and financing decisions, the firm may wish to consider local debt financing for investments in countries where the local currency is expected to depreciate on the foreign exchange market. The amount of local currency required to meet interest payments and retire principal on local debt obligations is not affected when a country's currency depreciates. However, if foreign debt obligations must be served, the amount of local currency required to do this will increase as the currency depreciates, and this effectively raises the cost of capital. Thus, although the initial cost of capital may be greater with local borrowing, it may be better to borrow locally if the local currency is expected to depreciate on the foreign exchange market.

Financial Management: Global Money Management

Money management decisions attempt to manage the firm's global cash resources—its working capital—most efficiently. This involves minimizing cash balances, reducing transaction costs, and minimizing the corporate tax burden.

MINIMIZING CASH BALANCES

LO6

Every business needs to hold some cash balances for servicing accounts that must be paid and for insuring against unanticipated negative variation from its projected cash flows. The critical issue for an international business is whether each foreign subsidiary should hold its own cash balances or whether cash balances should be held at a centralized depository. In general, firms prefer to hold cash balances at a centralized depository for three reasons.

First, by pooling cash reserves centrally, the firm can deposit larger amounts. Cash balances are typically deposited in liquid accounts, such as overnight money market accounts. Because interest rates on such deposits normally increase with the size of the deposit, by pooling cash centrally, the firm should be able to earn a higher interest rate than it would if each subsidiary managed its own cash balances.

Second, if the centralized depository is located in a major financial center (e.g., London, New York, or Tokyo), it should have access to information about good short-term investment opportunities that the typical foreign subsidiary would lack. Also, the financial experts at a centralized depository should be able to develop investment skills and know-how that managers in the typical foreign subsidiary would lack. Thus, the firm

should make better investment decisions if it pools its cash reserves at a centralized depository.

Third, by pooling its cash reserves, the firm can reduce the total size of the cash pool it must hold in highly liquid accounts, which enables the firm to invest a larger amount of cash reserves in longer-term, less liquid financial instruments that earn a higher interest rate. For example, a U.S. firm has three foreign subsidiaries—one in Korea, one in China, and one in Japan. Each subsidiary maintains a cash balance that includes an amount for dealing with its day-to-day needs plus a precautionary amount for dealing with unanticipated cash demands. The firm's policy is that the total required cash balance is equal to three standard deviations of the expected day-to-day-needs amount. The three-standard-deviation requirement reflects the firm's estimate that, in practice, there is a 99.87 percent probability that the subsidiary will have sufficient cash to deal with both day-to-day and unanticipated cash demands. Cash needs are assumed to be normally distributed in each country and independent of each other (e.g., cash needs in Japan do not affect cash needs in China).

The individual subsidiaries' day-to-day cash needs and the precautionary cash balances they should hold are as follows (in millions of dollars):

	Day-to-Day Cash Needs (A)	One Standard Deviation (B)	Required Cash Balance (A + 3 × B)
Korea	$10	$1	$13
China	6	2	12
Japan	12	3	21
Total	$28	$6	$46

Thus, the Korean subsidiary estimates that it must hold $10 million to serve its day-to-day needs. The standard deviation of this is $1 million, so it is to hold an additional $3 million as a precautionary amount. This gives a total required cash balance of $13 million. The total of the required cash balances for all three subsidiaries is $46 million.

Now consider what might occur if the firm decided to maintain all three cash balances at a centralized depository in Tokyo. Because variances are additive when probability distributions are independent of each other, the standard deviation of the combined precautionary account would be:

$$\begin{aligned} &\text{Square root of } (\$1{,}000{,}000^2 + 2{,}000{,}000^2 + 3{,}000{,}000^2) \\ &= \text{Square root of } 14{,}000{,}000 \\ &= \$3{,}741{,}657 \end{aligned}$$

Therefore, if the firm used a centralized depository, it would need to hold $28 million for day-to-day needs plus (3 × $3,741,657) as a precautionary amount, or a total cash balance of $39,224,971. In other words, the firm's total required cash balance would be reduced from $46 million to $39,224,971, a saving of $6,775,029. This is cash that could be invested in less liquid, higher-interest accounts or in tangible assets. The saving arises simply due to the statistical effects of summing the three independent, normal probability distributions.

However, a firm's ability to establish a centralized depository that can serve short-term cash needs might be limited by government-imposed restrictions on capital flows across borders (e.g., controls put in place to protect a country's foreign exchange reserves). Also, the transaction costs of moving money into and out of different currencies can limit the advantages of such a system. Despite this, many firms hold at least their subsidiaries'

precautionary cash reserves at a centralized depository, having each subsidiary hold its own day-to-day-needs cash balance. The globalization of the world capital market and the general removal of barriers to the free flow of cash across borders (particularly among advanced industrialized countries) are two trends likely to increase the use of centralized depositories.

REDUCING TRANSACTION COSTS

Transaction costs are the cost of exchange. Every time a firm changes cash from one currency into another currency it must bear a transaction cost—the commission fee it pays to foreign exchange dealers for performing the transaction. Most banks also charge a **transfer fee** for moving cash from one location to another; this is another transaction cost. The commission and transfer fees arising from intrafirm transactions can be substantial; according to the United Nations, 40 percent of international trade involves transactions between the different national subsidiaries of transnational corporations. The volume of such transactions is likely to be particularly high in a firm that has a globally dispersed web of interdependent value creation activities. Multilateral netting allows a multinational firm to reduce the transaction costs that arise when many transactions occur between its subsidiaries by reducing the number of transactions.

Multilateral netting is an extension of **bilateral netting**. Under bilateral netting, if a French subsidiary owes a Mexican subsidiary $6 million and the Mexican subsidiary simultaneously owes the French subsidiary $4 million, a bilateral settlement will be made with a single payment of $2 million from the French subsidiary to the Mexican subsidiary, the remaining debt being canceled.

Under **multilateral netting**, this simple concept is extended to the transactions between multiple subsidiaries within an international business. Consider a firm that wants to establish multilateral netting among four Asian subsidiaries based in Korea, China, Japan, and Taiwan. These subsidiaries all trade with each other, so at the end of each month a large volume of cash transactions must be settled. Figure 20.2A shows how the payment schedule might look at the end of a given month. Figure 20.2B is a payment matrix that summarizes the obligations among the subsidiaries. Note that $43 million needs to flow among the subsidiaries. If the transaction costs (foreign exchange commissions plus transfer fees) amount to 1 percent of the total funds to be transferred, this will cost the parent firm $430,000. However, this amount can be reduced by multilateral netting. Using the payment matrix (Figure 20.2B), the firm can determine the payments that need to be made among its subsidiaries to settle these obligations. Figure 20.2C shows the results. By multilateral netting, the transactions depicted in Figure 20.2A are reduced to just three; the Korean subsidiary pays $3 million to the Taiwanese subsidiary, and the Chinese subsidiary pays $1 million to the Japanese subsidiary and $1 million to the Taiwanese subsidiary. The total funds that flow among the subsidiaries are reduced

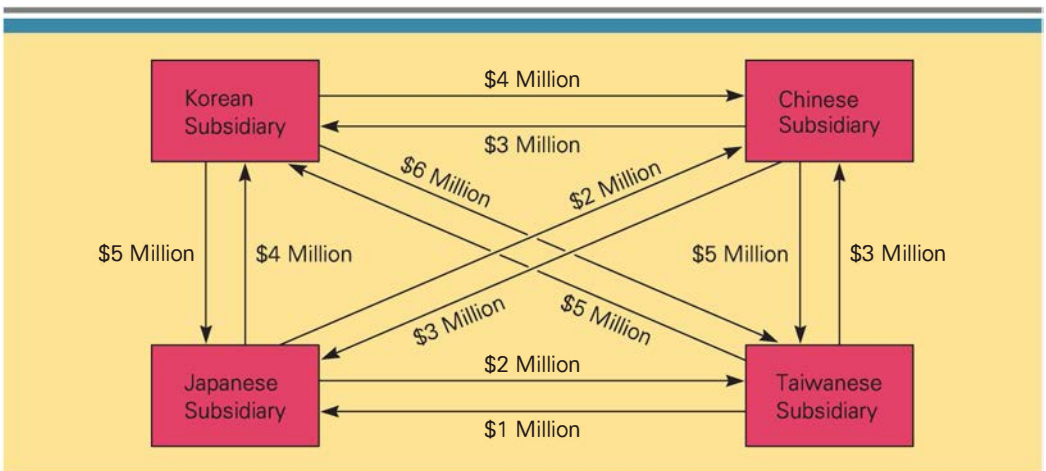


FIGURE 20.2A

Cash Flows before Multilateral Netting

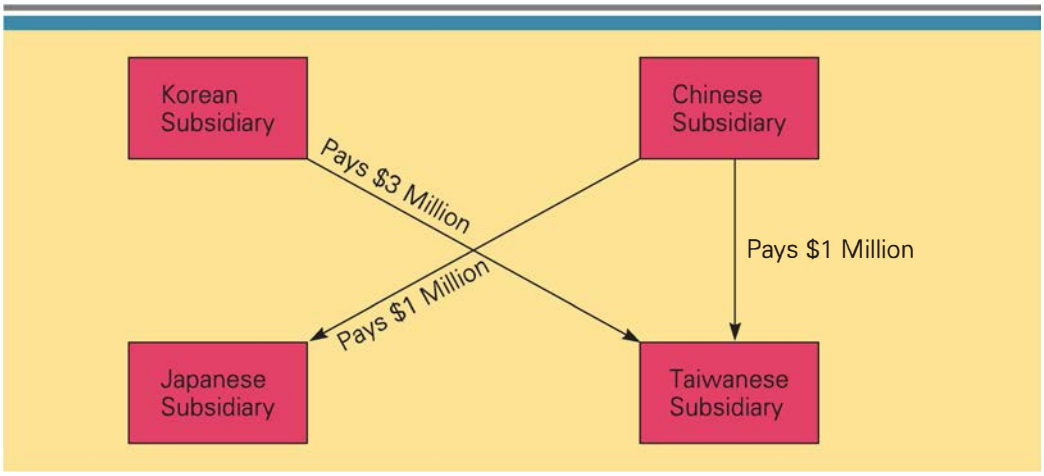
Receiving Subsidiary	Paying Subsidiary: Korea	China	Japan	Taiwan	Total Receipts	Net Receipts (payments)
Korean	—	$ 3	$4	$5	$12	($3)
Chinese	$ 4	—	2	3	9	(2)
Japanese	5	3	—	1	9	1
Taiwanese	6	5	2	—	13	4
Total payments	$15	$11	$8	$9		

FIGURE 20.2B

Calculation of Net Receipts (all amounts in millions)

FIGURE 20.2C

Cash Flows after Multilateral Netting



from $43 million to just $5 million, and the transaction costs are reduced from $430,000 to $50,000, a savings of $380,000 achieved through multilateral netting.

MANAGING THE TAX BURDEN

Different countries have different tax regimes. For example, among developed nations the top rates for corporate income tax varies from a high of 40.69 percent in Japan to a low of 12.5 percent in Ireland. In Germany and Japan, the tax rate is lower on income distributed to stockholders as dividends (36 and 35 percent, respectively), whereas in France the tax on profits distributed to stockholders is higher (42 percent). In the United States, the rate varies from state to state. The federal top rate is 35 percent, but states also tax corporate income, with state and local taxes ranging from 1 percent to 12 percent, hence the average effective rate of 40 percent.

Many nations follow the worldwide principle that they have the right to tax income earned outside their boundaries by entities based in their country.[17] Thus, the U.S. government can tax the earnings of the German subsidiary of an enterprise incorporated in the United States. Double taxation occurs when the income of a foreign subsidiary is taxed both by the host-country government and by the parent company's home government. However, double taxation is mitigated to some extent by tax credits, tax treaties, and the deferral principle.

A **tax credit** allows an entity to reduce the taxes paid to the home government by the amount of taxes paid to the foreign government. A **tax treaty** between two countries is an agreement specifying what items of income will be taxed by the authorities of the

country where the income is earned. For example, a tax treaty between the United States and Germany may specify that a U.S. firm need not pay tax in Germany on any earnings from its German subsidiary that are remitted to the United States in the form of dividends. A **deferral principle** specifies that parent companies are not taxed on foreign source income until they actually receive a dividend.

For the international business with activities in many countries, the various tax regimes and the tax treaties have important implications for how the firm should structure its internal payments system among the foreign subsidiaries and the parent company. As we will see in the next section, the firm can use transfer prices and fronting loans to minimize its global tax liability. In addition, the form in which income is remitted from a foreign subsidiary to the parent company (e.g., royalty payments versus dividend payments) can be structured to minimize the firm's global tax liability.

Some firms use **tax havens** such as the Bahamas and Bermuda to minimize their tax liability. A tax haven is a country with an exceptionally low, or even no, income tax. International businesses avoid or defer income taxes by establishing a wholly owned, nonoperating subsidiary in the tax haven. The tax haven subsidiary owns the common stock of the operating foreign subsidiaries. This allows all transfers of funds from foreign operating subsidiaries to the parent company to be funneled through the tax haven subsidiary. The tax levied on foreign source income by a firm's home government, which might normally be paid when a dividend is declared by a foreign subsidiary, can be deferred under the deferral principle until the tax haven subsidiary pays the dividend to the parent. This dividend payment can be postponed indefinitely if foreign operations continue to grow and require new internal financing from the tax haven affiliate. For U.S.-based enterprises, however, U.S. regulations tax U.S. shareholders on the firm's overseas income when it is earned, regardless of when the parent company in the United States receives it. This regulation eliminates U.S.-based firms' ability to use tax haven subsidiaries to avoid tax liabilities in the manner just described.

MOVING MONEY ACROSS BORDERS LO7

Pursuing the objectives of utilizing the firm's cash resources most efficiently and minimizing the firm's global tax liability requires the firm to be able to transfer funds from one location to another around the globe. International businesses use a number of techniques to transfer liquid funds across borders. These include dividend remittances, royalty payments and fees, transfer prices, and fronting loans. Some firms rely on more than one of these techniques to transfer funds across borders—a practice known as unbundling. By using a mix of techniques to transfer liquid funds from a foreign subsidiary to the parent company, unbundling allows an international business to recover funds from its foreign subsidiaries without piquing host-country sensitivities with large "dividend drains."

A firm's ability to select a particular policy is severely limited when a foreign subsidiary is part-owned either by a local joint-venture partner or by local stockholders. Serving the legitimate demands of the local co-owners of a foreign subsidiary may limit the firm's ability to impose the kind of dividend policy, royalty payment schedule, or transfer pricing policy that would be optimal for the parent company.

Dividend Remittances

Payment of dividends is the most common method by which firms transfer funds from foreign subsidiaries to the parent company. The dividend policy typically varies with each subsidiary depending on such factors as tax regulations, foreign exchange risk, the age of the subsidiary, and the extent of local equity participation. For example, the higher the rate of tax levied on dividends by the host-country government, the less attractive this option becomes relative to other options for transferring liquid funds. With regard to foreign exchange risk, firms sometimes require foreign subsidiaries based in "high-risk" countries to speed up the transfer of funds to the parent through accelerated

dividend payments. This moves corporate funds out of a country whose currency is expected to depreciate significantly. The age of a foreign subsidiary influences dividend policy in that older subsidiaries tend to remit a higher proportion of their earnings in dividends to the parent, presumably because a subsidiary has fewer capital investment needs as it matures. Local equity participation is a factor because local co-owners' demands for dividends must be recognized.

Royalty Payments and Fees

Royalties represent the remuneration paid to the owners of technology, patents, or trade names for the use of that technology or the right to manufacture and/or sell products under those patents or trade names. It is common for a parent company to charge its foreign subsidiaries royalties for the technology, patents, or trade names it has transferred to them. Royalties may be levied as a fixed monetary amount per unit of the product the subsidiary sells or as a percentage of a subsidiary's gross revenues.

A fee is compensation for professional services or expertise supplied to a foreign subsidiary by the parent company or another subsidiary. Fees are sometimes differentiated into "management fees" for general expertise and advice and "technical assistance fees" for guidance in technical matters. Fees are usually levied as fixed charges for the particular services provided.

Royalties and fees have certain tax advantages over dividends, particularly when the corporate tax rate is higher in the host country than in the parent's home country. Royalties and fees are often tax-deductible locally (because they are viewed as an expense), so arranging for payment in royalties and fees will reduce the foreign subsidiary's tax liability. If the foreign subsidiary compensates the parent company by dividend payments, local income taxes must be paid before the dividend distribution, and withholding taxes must be paid on the dividend itself. Although the parent can often take a tax credit for the local withholding and income taxes it has paid, part of the benefit can be lost if the subsidiary's combined tax rate is higher than the parent's.

Transfer Prices

Any international business normally involves a large number of transfers of goods and services between the parent company and foreign subsidiaries and between foreign subsidiaries. This is particularly likely in firms pursuing global and transnational strategies because these firms are likely to have dispersed their value creation activities to various "optimal" locations around the globe (see Chapter 13). As noted earlier, the price at which goods and services are transferred between entities within the firm is referred to as the transfer price.[18]

Transfer prices can be used to position funds within an international business. For example, funds can be moved out of a particular country by setting high transfer prices for goods and services supplied to a subsidiary in that country and by setting low transfer prices for the goods and services sourced from that subsidiary. Conversely, funds can be positioned in a country by the opposite policy: setting low transfer prices for goods and services supplied to a subsidiary in that country and setting high transfer prices for the goods and services sourced from that subsidiary. This movement of funds can be between the firm's subsidiaries or between the parent company and a subsidiary.

At least four gains can be derived by adjusting transfer prices.

1. The firm can reduce its tax liabilities by using transfer prices to shift earnings from a high-tax country to a low-tax one.
2. The firm can use transfer prices to move funds out of a country where a significant currency devaluation is expected, thereby reducing its exposure to foreign exchange risk.
3. The firm can use transfer prices to move funds from a subsidiary to the parent company (or a tax haven) when financial transfers in the form of dividends are restricted or blocked by host-country government policies.

4. The firm can use transfer prices to reduce the import duties it must pay when an ad valorem tariff is in force—a tariff assessed as a percentage of value. In this case, low transfer prices on goods or services being imported into the country are required. Since this lowers the value of the goods or services, it lowers the tariff.

However, significant problems are associated with pursuing a transfer pricing policy.[19] Few governments like it.[20] When transfer prices are used to reduce a firm's tax liabilities or import duties, most governments feel they are being cheated of their legitimate income. Similarly, when transfer prices are manipulated to circumvent government restrictions on capital flows (e.g., dividend remittances), governments perceive this as breaking the spirit—if not the letter—of the law. Many governments now limit international businesses' ability to manipulate transfer prices in the manner described. The United States has strict regulations governing transfer-pricing practices. According to Section 482 of the Internal Revenue Code, the Internal Revenue Service (IRS) can reallocate gross income, deductions, credits, or allowances between related corporations to prevent tax evasion or to reflect more clearly a proper allocation of income. Under the IRS guidelines and subsequent judicial interpretation, the burden of proof is on the taxpayer to show that the IRS has been arbitrary or unreasonable in reallocating income. The correct transfer price, according to the IRS guidelines, is an arm's-length price—the price that would prevail between unrelated firms in a market setting. Such a strict interpretation of what is a correct transfer price theoretically limits a firm's ability to manipulate transfer prices to achieve the benefits we have discussed. Many other countries have followed the U.S. lead in emphasizing that transfer prices should be set on an arm's-length basis.

Another problem associated with transfer pricing is related to management incentives and performance evaluation.[21] Transfer pricing is inconsistent with a policy of treating each subsidiary in the firm as a profit center. When transfer prices are manipulated by the firm and deviate significantly from the arm's-length price, the subsidiary's performance may depend as much on transfer prices as it does on other pertinent factors, such as management effort. A subsidiary told to charge a high transfer price for a good supplied to another subsidiary will appear to be doing better than it actually is, while the subsidiary purchasing the good will appear to be doing worse. Unless this is recognized when performance is being evaluated, serious distortions in management incentive systems can occur. For example, managers in the selling subsidiary may be able to use high transfer prices to mask inefficiencies, while managers in the purchasing subsidiary may become disheartened by the effect of high transfer prices on their subsidiary's profitability.

Despite these problems, research suggests that not all international businesses use arm's-length pricing but instead use some cost-based system for pricing transfers among their subunits (typically cost plus some standard markup). A survey of 164 U.S. multinational firms found that 35 percent of the firms used market-based prices, 15 percent used negotiated prices, and 65 percent used a cost-based pricing method. (The figures add up to more than 100 percent because some companies use more than one method.)[22] Only market and negotiated prices could reasonably be interpreted as arm's-length prices. The opportunity for price manipulation is much greater with cost-based transfer pricing. Other more sophisticated research has uncovered indirect evidence that many corporations do manipulate transfer prices in order to reduce global tax liabilities.[23]

Although a firm may be able to manipulate transfer prices to avoid tax liabilities or circumvent government restrictions on capital flows across borders, this does not mean the firm should do so. Since the practice often violates at least the spirit of the law in many countries, the ethics of engaging in transfer pricing are dubious at best. Also, there are clear signs that tax authorities in many countries are increasing their scrutiny of this practice in order to stamp out abuses. A survey of some 600 multinationals undertaken by accountants at Ernst & Young found that 75 percent of them believed they would be

the subject of a transfer pricing audit by tax authorities in the next two years.[24] Some 61 percent of the multinationals in the survey stated that transfer pricing was the top tax issue that they faced.

Fronting Loans

A fronting loan is a loan between a parent and its subsidiary channeled through a financial intermediary, usually a large international bank. In a direct intrafirm loan, the parent company lends cash directly to the foreign subsidiary, and the subsidiary repays it later. In a fronting loan, the parent company deposits funds in an international bank, and the bank then lends the same amount to the foreign subsidiary. Thus, a U.S. firm might deposit $100,000 in a London bank. The London bank might then lend that $100,000 to an Indian subsidiary of the firm. From the bank's point of view, the loan is risk free because it has 100 percent collateral in the form of the parent's deposit. The bank "fronts" for the parent, hence the name. The bank makes a profit by paying the parent company a slightly lower interest rate on its deposit than it charges the foreign subsidiary on the borrowed funds.

Firms use fronting loans for two reasons. First, fronting loans can circumvent host-country restrictions on the remittance of funds from a foreign subsidiary to the parent company. A host government might restrict a foreign subsidiary from repaying a loan to its parent in order to preserve the country's foreign exchange reserves, but it is less likely to restrict a subsidiary's ability to repay a loan to a large international bank. To stop payment to an international bank would hurt the country's credit image, whereas halting payment to the parent company would probably have a minimal impact on its image. Consequently, international businesses sometimes use fronting loans when they want to lend funds to a subsidiary based in a country with a fairly high probability of political turmoil that might lead to restrictions on capital flows (i.e., where the level of political risk is high).

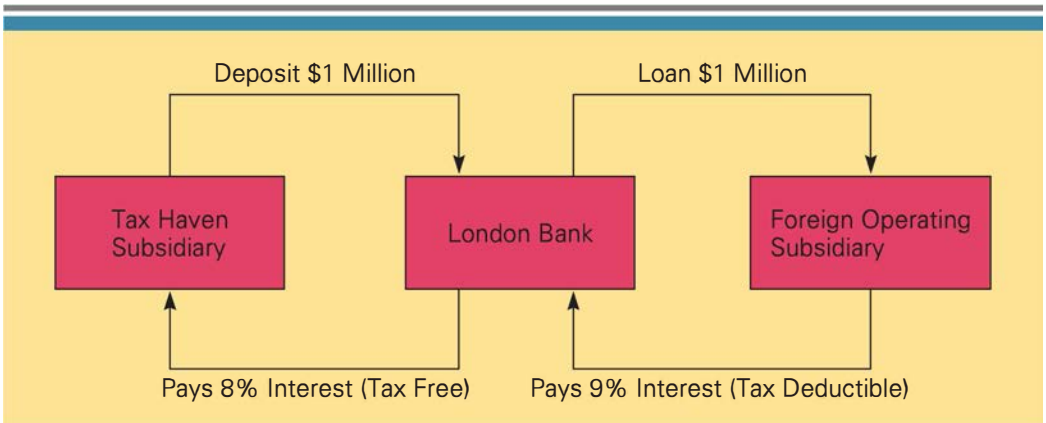
A fronting loan can also provide tax advantages. For example, a tax haven (Bermuda) subsidiary that is 100 percent owned by the parent company deposits $1 million in a London-based international bank at 8 percent interest. The bank lends the $1 million to a foreign operating subsidiary at 9 percent interest. The country where the foreign operating subsidiary is based taxes corporate income at 50 percent (see Figure 20.3).

Under this arrangement, interest payments net of income tax will be as follows:

1. The foreign operating subsidiary pays $90,000 interest to the London bank. Deducting these interest payments from its taxable income results in a net after-tax cost of $45,000 to the foreign operating subsidiary.
2. The London bank receives the $90,000. It retains $10,000 for its services and pays $80,000 interest on the deposit to the Bermuda subsidiary.
3. The Bermuda subsidiary receives $80,000 interest on its deposit tax-free.

FIGURE 20.3

An Example of the Tax Aspects of a Fronting Loan



The net result is that $80,000 in cash has been moved from the foreign operating subsidiary to the tax haven subsidiary. Because the foreign operating subsidiary's after-tax cost of borrowing is only $45,000, the parent company has moved an additional $35,000 out of the country by using this arrangement. If the tax haven subsidiary had made a direct loan to the foreign operating subsidiary, the host government may have disallowed the interest charge as a tax-deductible expense by ruling that it was a dividend to the parent disguised as an interest payment.

CHAPTER SUMMARY

This chapter focused on accounting and financial management in the international business. It explained why accounting practices and standards differ from country to country and surveyed the efforts under way to harmonize countries' accounting practices. We reviewed several issues related to the use of accounting-based control systems within international businesses. We discussed how investment decisions, financing decisions, and money management decisions are complicated by the fact that different countries have different currencies, different tax regimes, different levels of political and economic risk, and so on. This chapter made the following points:

1. Each country's accounting system evolved in response to the local demands for accounting information. National differences in accounting and auditing standards resulted in a general lack of comparability in countries' financial reports.
2. This lack of comparability has become a problem as transnational financing and transnational investment have grown rapidly in recent decades (a consequence of the globalization of capital markets). Due to the lack of comparability, a firm may have to explain to investors why its financial position looks very different on financial reports that are based on different accounting practices.
3. The most significant push for harmonization of accounting standards across countries has come from the International Accounting Standards Board (IASB).
4. In most international businesses, the annual budget is the main instrument by which headquarters controls foreign subsidiaries. Throughout the year, headquarters compares a subsidiary's performance against the financial goals incorporated in its budget, intervening selectively in its operations when shortfalls occur.
5. Most international businesses require all budgets and performance data within the firm to be expressed in the corporate currency. This enhances comparability, but it distorts the control process if the relevant exchange rates change between the time a foreign subsidiary's budget is set and the time its performance is evaluated. According to the Lessard–Lorange model, the best way to deal with this problem is to use a projected spot exchange rate to translate both budget figures and performance figures into the corporate currency.
6. Transfer prices also can introduce significant distortions into the control process and thus must be considered when setting budgets and evaluating a subsidiary's performance.
7. When using capital budgeting techniques to evaluate a potential foreign project, the firm needs to recognize the specific risks arising from its foreign location. These include political risks and economic risks (including foreign exchange risk). Political and economic risks can be incorporated into the capital budgeting process by using a higher discount rate to evaluate risky projects or by forecasting lower cash flows for such projects.
8. The cost of capital is lower in the global capital market than in domestic markets. Consequently, other things being equal, firms prefer to finance their investments by borrowing from the global capital market.
9. Borrowing from the global capital market may be restricted by host-government regulations or demands. In such cases, the discount rate used in capital budgeting must be revised upward to reflect this.
10. The firm may want to consider local debt financing for investments in countries where the local currency is expected to depreciate.
11. The principal objectives of global money management are to utilize the firm's cash resources in the most efficient manner and to minimize the firm's global tax liabilities.

12. By holding cash at a centralized depository, the firm may be able to invest its cash reserves more efficiently. It can reduce the total size of the cash pool that it needs to hold in highly liquid accounts, thereby freeing cash for investment in higher-interest-bearing (less liquid) accounts or in tangible assets.
13. Firms use a number of techniques to transfer funds across borders, including dividend remittances, royalty payments and fees, transfer prices, and fronting loans. Dividend remittances are the most common method used for transferring funds across borders, but royalty payments and fees have certain tax advantages over dividend remittances.
14. The manipulation of transfer prices may be used by firms to move funds out of a country to minimize tax liabilities, hedge against foreign exchange risk, circumvent government restrictions on capital flows, and reduce tariff payments. However, manipulating transfer prices in this manner runs counter to government regulations in many countries, it may distort incentive systems within the firm, and it has ethically dubious foundations.
15. Fronting loans involves channeling funds from a parent company to a foreign subsidiary through a third party, normally an international bank. Fronting loans can circumvent host-government restrictions on the remittance of funds and provide certain tax advantages.

Critical Thinking and Discussion Questions

1. Why do the accounting systems of different countries differ? Why do these differences matter?
2. Why might an accounting-based control system provide headquarters management with biased information about the performance of a foreign subsidiary? How can these biases best be corrected?
3. You are the CFO of a U.S. firm whose wholly owned subsidiary in Mexico manufactures component parts for your U.S. assembly operations. The subsidiary has been financed by bank borrowings in the United States. One of your analysts told you that the Mexican peso is expected to depreciate by 30 percent against the dollar on the foreign exchange markets over the next year. What actions, if any, should you take?
4. You are the CFO of a Canadian firm that is considering building a $10 million factory in Russia to produce milk. The investment is expected to produce net cash flows of $3 million each year for the next 10 years, after which the investment will have to close because of technological obsolescence. Scrap values will be zero. The cost of capital will be 6 percent if financing is arranged through the Eurobond market. However, you have an option to finance the project by borrowing funds from a Russian bank at 12 percent. Analysts tell you that due to high inflation in Russia, the Russian ruble is expected to depreciate against the Canadian dollar. Analysts also rate the probability of violent revolution occurring in Russia within the next 10 years as high. How would you incorporate these factors into your evaluation of the investment opportunity? What would you recommend the firm do?

Research Task globalEDGE globaledge.msu.edu

Accounting and Finance in the International Business

Use the globalEDGE™ site to complete the following exercises:

Exercise 1

The inflation rate of a country can impact the valuation of multinational corporation's assets. In fact, your U.S.-based company has operations in the following countries: Belarus, Costa Rica, Egypt, Finland, Ghana, Iceland, Paraguay, Thailand, and Zimbabwe. Based on the most recent inflation data available, categorize each country's asset devaluation from highest to lowest. Be sure to use the globalEDGE™ website's "country comparator" tool that allows investigators to compare countries based on statistical indicators.

Exercise 2

Country risk is an important issue for international investors to consider. As your firm is looking to invest in the Middle East, use the *@rating* resource to identify and present the country ratings for each of the following Middle Eastern countries: Egypt, Israel, Lebanon, Qatar, and the United Arab Emirates. Which country would you recommend for investment? Justify your position thoroughly.

CLOSING CASE

Brazil's Gol Airlines

Brazil's Gol Linhas Aereas Inteligentes is a tropical version of JetBlue Airways and Ryanair, the low-cost, no-frills carriers in the United States and Europe. Established in 2001, Gol adopted the low-cost model pioneered by Southwest Airlines and refined by the likes of JetBlue and Ryanair. Gol sells discount tickets, mainly over the Internet. It targets price-sensitive business travelers, who account for 70 percent of all traffic in Brazil's rapidly growing market for air travel (demand for air travel in Brazil is growing at roughly twice the rate of growth in the country's gross domestic product). Gol is also going after Brazil's large bus market; in 2001 some 130 million people in Brazil traveled by interstate bus companies. Gol has standardized its fleet on a single aircraft model, Boeing's 737 series. There are no airport clubs or frequent flyer programs, cabins are a single class, and light snacks and beverages replace meals. The airline also offers Internet check-in and delivers a reliable product, with 95 percent of flights arriving on time. Gol's service has elicited a remarkable response from customers, with an independent market research survey finding that more than 90 percent of customers would continue to use the airline and recommend it to others.

From a standing start in January 2001, this business model enabled Gol to capture a 22 percent share of the Brazilian market by mid-2004. By then, Gol had a fleet of 25 aircraft and was already ranked as one of the fastest-growing and most profitable airlines in the world, but its aspirations are much bigger. Gol wants to be the low-cost carrier in South America. To get to that point, it planned to expand its fleet to some 69 aircraft by 2010.

To help finance this expansion, Gol decided to tap into the global capital market. In mid-2004 the privately held company offered nonvoting preferred stock to investors on the Sao Paulo Bovespa and the New York Stock Exchange. The simultaneous offering was oversubscribed, with the underwriters lifting the offering price twice, and raised some $322 million. In explaining the decision to offer stock through the New York Stock Exchange, Gol's chief financial officer noted, "We wanted to get a solid group of long-term investors that understood the business. We've got that. We also wanted to get a group of research analysts that understood this sector, and we now have seven analysts covering the stock. Southwest, JetBlue, Ryanair, and Westjet are considered the tier one in terms of operating profitability and successes. We were able to put Gol right up in that group. Doing both the NYSE and Bovespa was part of our strategy to sell shares to investors that have familiarity with low-cost carriers. The strategy works. If you look at the list of major investors in the company, the majority of them have high positions in trade of the equities of JetBlue, Southwest, and Ryanair. For them, it was a very easy analysis to understand Gol's business model and how it makes money."

Aided by the financing, Gol was able to expand rapidly. By early 2007 it already had 65 aircraft and was operating 600 daily flights to 55 destinations, including seven international routes to five South American countries. Gol had a market share of 36 percent for routes within Brazil and 13 percent on international routes originating in Brazil. Its planes were 74 percent full on average, the best in Brazil, and it was the most punctual airline in Brazil. By early 2011, Gol surpassed its local rival, TAM, to become the largest airline in Brazil, accounting for 40 percent of the domestic market.[25]

Case Discussion Questions

1. What were the benefits to Gol of a listing on the New York Stock Exchange in addition to the Sao Paulo Bovespa?
2. Why do you think the Gol stock offering was oversubscribed?
3. Do you think Gol would have raised as much money if it had just listed on the new Sao Paulo exchange?
4. How might the joint listing of the New York and Sao Paulo stock exchanges affect Gol's ability to raise additional capital in the future?

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part Six cases

Building the Boeing 787 668

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Building the Boeing 787

Boeing's newest commercial jet aircraft, the wide-body 787 jet, is a bold bet on the future of both airline travel and plane making. Designed to fly long-haul point-to-point routes, the 250-seat 787 is made largely of composite materials, such as carbon fibers, rather than traditional materials such as aluminum. Some 80 percent of the 787 by volume is composite materials, making the plane 20 percent lighter than a traditional aircraft of the same size, which translates into a big saving in jet fuel consumption and costs. The 787 is also packed full of other design innovations, including larger windows, greater headroom, and state-of-the-art electronics on the flight deck and in the passenger compartment.

To reduce the risks associated with this technological gamble, Boeing decided to outsource an unprecedented 70 percent of the content of the 787 to other manufacturers, most of them based in other nations. In contrast, 50 percent of the Boeing 777 was outsourced, 30 percent of the 767, and only 5 percent of the 707. The idea was that in return for a share of the work, partners would contribute to the estimated $8 billion in development costs for the 787. In addition, by outsourcing, Boeing believed it could tap into the expertise of the most efficient producers, wherever in the world they might be located, thereby driving down the costs of making the plane. Furthermore, Boeing believed that outsourcing some work to foreign countries would help it to garner sales in those countries. Boeing's role in the entire process was to design the plane, market and sell it, and undertake final assembly in its plant in Everett, Washington. Boeing also believed that by outsourcing the design of so many components, it could cut down the time to develop this aircraft to four years from the six that is normal in the industry.

Some 17 partners in 10 countries were selected to produce major parts of the aircraft. The rear fuselage was to be made by Vought Aircraft Industries in South Carolina; Alenia Aeronautical of Italy was to make the middle fuselage sections and horizontal tailpieces. Three Japanese companies, Fuji, Kawasaki, and Mitsubishi, were to produce the wings. The nose section was to be made by Toronto-based Onex Corporation. All of these bulky pieces were to be shipped to Everett for final assembly aboard a fleet of three modified Boeing 747 freighters called Dreamlifters.

Until late 2007, the strategy seemed to be working remarkably well. Boeing had booked orders for over 770 aircraft, worth more than $100 billion, making the 787 the most successful aircraft launch in the history of commercial aviation. But behind the scenes, cracks were appearing in Boeing's globally dispersed supply chain. In mid-2007, Boeing admitted the 787 might be a few months late due to problems with the supply of special fasteners for the fuselage. As it turned out, the problems were much more serious. By early 2008 Boeing was admitting to a delay of up to 12 months in the delivery of the first 787, an additional $2 billion in development costs, and the possibility of having to pay millions in penalty clause payments for late delivery to its leading customers.

The core issue was that several key partners had not been able to meet Boeing's delivery schedules. To make composite parts, for example, Italy's Alenia had to build a new factory, but the site that it chose was a 300-year-old olive grove, and it faced months of haggling with local authorities and had to agree to replant the trees elsewhere before it could break ground. To compound problems, its first fuselage sections delivered to Boeing did not meet the required quality standards. Then when parts did arrive at Everett, Boeing found that many components had not been installed in the fuselages (as required), and that assembly instructions were available only in Italian. Other problems arose because several partners outsourced mission-critical design work to other enterprises. Vought, for example, outsourced the design and building of floor pieces for which it was responsible to an Israeli company. In turn, the Israeli company had trouble meeting Boeing's exacting quality standards. However, because it was reporting to Vought, not Boeing, executives at Boeing did not learn of this until it had already become a serious bottleneck. Upon learning of the issue, Boeing rapidly dispatched engineers to Israel to work with the company, but by now several months had been lost. Boeing also subsequently acquired Vought in 2009, bringing the supplier in-house.

Despite all of these issues, Boeing remains committed to its outsourcing program. However, the company has learned that if it is going to outsource work to foreign suppliers, much closer management oversight and coordination is required to make it work. The company has also indicated that as valuable as outsourcing can be, it probably went too far with the 787. Going forward, Boeing has signaled that it will not outsource key components that are seen as a source of Boeing's competitive advantage (wings, in particular, are often mentioned as a component that may not be outsourced for future aircraft models).[1]

Case Discussion Questions

1. What are the benefits to Boeing of outsourcing so much work on the 787 to foreign suppliers? What are the potential risks? Do the benefits outweigh the risk?
2. In 2007 and 2008 Boeing ran into several publicized issues with regard to its management of a globally

dispersed supply chain. What are the causes of these problems? What can a company like Boeing do to make sure such problems do not occur in the future?

3. Some critics have claimed that by outsourcing so much work, Boeing has been exporting American jobs overseas. Is this criticism fair? How should the company respond to such criticisms?

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Adopting International Accounting Standards

Following a European Union mandate, from January 1, 2005, onward, some 7,000 companies whose stock is publicly traded on European stock exchanges were required to issue all future financial accounts in a format agreed upon by the International Accounting Standards Board (IASB). In addition, some 65 countries outside of the EU have also committed to requiring that public companies issue accounts that conform to IASB rules. Even American accounting authorities, who historically have not been known for cooperating on international projects, have been trying to mesh their rules with those of the IASB.

Historically, different accounting practices made it very difficult for investors to compare the financial statements of firms based in different nations. For example, after the 1997 Asian crisis, a UN analysis concluded that before the crisis two-thirds of the 73 largest East Asian banks hadn't disclosed problem loans and debt from related parties, such as loans between a parent and its subsidiary. About 85 percent of the banks didn't disclose their gains or losses from foreign currency translations or their net foreign currency exposures, and two-thirds failed to disclose the amounts they had invested in derivatives. Had this accounting information been made available to the public—as it would have been under accounting standards prevailing at the time in many developed nations—it is possible that problems in the East Asian banking system would have come to light sooner, and the crisis that unfolded in 1997 might not have been as serious as it ultimately was.

In another example of the implications of differences in accounting standards, a Morgan Stanley research project found that country differences in the way corporate pension expenses are accounted for distorted the earnings statements of companies in the automobile industry. Most strikingly, while U.S. auto companies charged certain pension costs against earnings and funded them annually, Japanese auto companies took no charge against earnings for pension costs, and their pension obligations were largely unrecorded. By adjusting for these differences, Morgan Stanley found that the U.S. companies generally understated their earnings, and had stronger balance sheets, than commonly supposed, whereas Japanese companies had lower earnings and weaker balance sheets. By putting everybody on the same footing, the move toward common global accounting standards should eliminate such divergent practices and make cross-national comparisons easier.

However, the road toward common accounting standards has some speed bumps. In November 2004, for example, Shell, the large oil company, announced that adopting international accounting standards would reduce the value of assets on its balance sheet by $4.9 billion. The reduction primarily came from a change in the way Shell must account for employee benefits, such as pensions. Similarly, following IASB standards, the net worth of the French cosmetics giant L'Oreal fell from 8.1 billion to 6.3 billion euros, primarily due to a change in the way certain classes of stock were classified. On the other hand, some companies will benefit from the shift. The UK-based mobile phone giant Vodafone, for example, announced in early 2005 that under newly adopted IASB standards, its reported profits for the last six months of 2004 would have been some $13 billion higher, primarily because the company would not have had to amortize goodwill associated with previous acquisitions against earnings.[1]

Case Discussion Questions

1. What are the benefits of adopting international accounting standards for (a) investors and (b) business enterprises?
2. What are the potential risks associated with a move in a nation toward adoption of international accounting standards?
3. In which nation is the move to adoption of IASB standards likely to cause revisions in the reported financial performance of business enterprises, the United States or China? Why?

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Li & Fung

Established in 1906, Hong Kong-based Li & Fung is now one of the largest multinational trading companies in the developing world, with annual sales of over $11 billion in 2008, up from just $1.2 billion in 2000. The company, which is still run by the founder's grandsons, Victor and William Fung, does not see itself as a traditional trading enterprise. Rather, it sees itself as an expert in supply chain management for its 500 or so customers. These customers are a diverse group and include clothing retailers and consumer electronics companies. Li & Fung takes orders from customers and then sifts through its network of 7,500 independent suppliers located in 40 countries to find the right manufacturing enterprises to produce the product for customers at the most attractive combination of cost and quality. Attaining this goal frequently requires Li & Fung to break up the value chain and disperse different productive activities to manufacturers located in different countries depending on an assessment of factors such as labor costs, trade barriers, transportation costs, and so on. Li & Fung then coordinates the whole process, managing the logistics and arranging for the shipment of the finished product to the customer.

Typical of its customers is The Limited, Inc., a large U.S.-based chain of retail clothing stores. The Limited outsources much of its manufacturing and logistics functions to Li & Fung. The process starts when The Limited comes to Li & Fung with designer sketches of clothes for the next fashion season. Li & Fung takes the basic product concepts and researches the market to find the right kind of yarn, dye, buttons, and so on, then assembles these into prototypes that The Limited can inspect. Once The Limited has settled on a prototype, it will give Li & Fung an order and ask for delivery within five weeks. The short time between an order and requested delivery is necessitated by the rapid rate of product obsolescence in the fashion clothing industry.

With order in hand, Li & Fung distributes the various aspects of the overall manufacturing process to different producers depending on their capabilities and costs. For example, Li & Fung might decide to purchase yarn from a Korean company but have it woven and dyed in Taiwan. So Li & Fung will arrange for the yarn to be picked up from Korea and shipped to Taiwan. The Japanese might have the best zippers and buttons, but they manufacture them mostly in China. So Li & Fung will go to YKK, a big Japanese zipper manufacturer, and order the right zippers from their Chinese plants. Then Li & Fung might decide that due to constraints imposed by export quotas and labor costs, the best place to make the final garments might be in Thailand. So everything will be shipped to Thailand. In addition, because The Limited, like many retail customers, needs quick delivery, Li & Fung might divide the order across five factories in Thailand. Five weeks after the order has been received, the garments will arrive on the shelves of The Limited, all looking like they came from one factory, with colors perfectly matched. The result is a product that may have a label that says "Made in Thailand," but is a global product.

To better serve the needs of its customers, Li & Fung is divided into numerous small, customer-focused divisions. There is a theme store division that serves a handful of customers such as Warner Brothers, there is a division for The Limited, and another for Gymboree, a U.S.-based children's clothing store. Walk into one of these divisions, such as the Gymboree division, and you will see that every one of the 40 or so people in the division is focused solely on meeting Gymboree's needs. On every desk is a computer with a direct software link to Gymboree. The staff is organized into specialized teams in areas such as design, technical support, merchandising, raw material purchasing, quality assurance, and shipping. These teams also have direct electronic links to dedicated staff in Li & Fung's branch offices in various countries where Gymboree buys in volume, such as China, Indonesia, and the Philippines. Thus, Li & Fung uses information systems to manage, coordinate, and control the globally dispersed design, production, and shipping process to ensure that the time between receipt of an order and delivery is minimized, as are overall costs.[1]

Case Discussion Questions

1. What are the benefits to Li & Fung's customers of working with the company? Why do companies such as The Limited outsource the coordination of manufacturing to Li & Fung, rather than do it themselves?
2. Li & Fung does no manufacturing itself. What then is its role? How does the company create value?
3. What do you think drives the choices that Li & Fung makes about who should produce what for its clients?
4. What is the source of Li & Fung's competitive advantage in the global economy?

Sources

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GLOSSARY

A

absolute advantage A country has an absolute advantage in the production of a product when it is more efficient than any other country at producing it.

accounting standards Rules for preparing financial statements.

ad valorem tariff A tariff levied as a proportion of the value of an imported good.

administrative trade policies Administrative policies, typically adopted by government bureaucracies, that can be used to restrict imports or boost exports.

Andean Pact A 1969 agreement between Bolivia, Chile, Ecuador, Colombia, and Peru to establish a customs union.

antidumping policies Designed to punish foreign firms that engage in dumping and thus protect domestic producers from unfair foreign competition.

antidumping regulations Regulations designed to restrict the sale of goods for less than their fair market price.

arbitrage The purchase of securities in one market for immediate resale in another to profit from a price discrepancy.

Association of South East Asian Nations (ASEAN) Formed in 1967, an attempt to establish a free trade area between Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

auditing standards Rules for performing an audit.

B

backward vertical FDI Investing in an industry abroad that provides inputs for a firm's domestic processes.

balance-of-payments accounts National accounts that track both payments to and receipts from foreigners.

balance-of-trade equilibrium Reached when the income a nation's residents earn from exports equals money paid for imports.

banking crisis A loss of confidence in the banking system that leads to a run on banks, as individuals and companies withdraw their deposits.

barriers to entry Factors that make it difficult or costly for firms to enter an industry or market.

barter The direct exchange of goods or services between two parties without a cash transaction.

basic research centers Centers for fundamental research located in regions where valuable scientific knowledge is being created; they develop the basic technologies that become new products.

bilateral netting Settlement in which the amount one subsidiary owes another can be canceled by the debt the second subsidiary owes the first.

bill of exchange An order written by an exporter instructing an importer, or an importer's agent, to pay a specified amount of money at a specified time.

bill of lading A document issued to an exporter by a common carrier transporting merchandise. It serves as a receipt, a contract, and a document of title.

Bretton Woods A 1944 conference in which representatives of 40 countries met to design a new international monetary system.

bureaucratic controls Achieving control through establishment of a system of rules and procedures.

business ethics The accepted principles of right or wrong governing the conduct of businesspeople.

buyback Agreement to accept a percentage of a plant's output as payment for contract to build a plant.

C

capital account In the balance of payments, records transactions involving the purchase or sale of assets.

capital controls Restrictions on cross-border capital flows that segment different stock markets; limit amount of a firm's stock a foreigner can own; and limit a citizen's ability to invest outside the country.

capital flight Converting domestic currency into a foreign currency.

CARICOM An association of English-speaking Caribbean states that are attempting to establish a customs union.

carry trade A kind of speculation that involves borrowing in one currency where interest rates are low, and then using the proceeds to invest in another currency where interest rates are high.

caste system A system of social stratification in which social position is determined by the family into which a person is born, and change in that position is usually not possible during an individual's lifetime.

centralized depository The practice of centralizing corporate cash balances in a single depository.

channel length The number of intermediaries that a product has to go through before it reaches the final consumer.

civil law system A system of law based on a very detailed set of written laws and codes.

class consciousness A tendency for individuals to perceive themselves in terms of their class background.

class system A system of social stratification in which social status is determined by the family into which a person is born and by subsequent socioeconomic achievements. Mobility between classes is possible.

code of ethics A formal statement of the ethical priorities of a business or organization.

collectivism An emphasis on collective goals as opposed to individual goals.

COMECON Now-defunct economic association of Eastern European Communist states headed by the former Soviet Union.

command economy An economic system where the allocation of resources, including determination of what goods and services should be produced, and in what quantity, is planned by the government.

common law system A system of law based on tradition, precedent, and custom. When law courts interpret common law, they do so with regard to these characteristics.

common market A group of countries committed to (1) removing all barriers to the free flow of goods, services, and factors of production between each other and (2) the pursuit of a common external trade policy.

communist totalitarianism A version of collectivism advocating that socialism can be achieved only through a totalitarian dictatorship.

communists Those who believe socialism can be achieved only through revolution and totalitarian dictatorship.

comparative advantage The theory that countries should specialize in the production of goods and services they can produce most efficiently. A country is said to have a comparative advantage in the production of such goods and services.

competition policy Regulations designed to promote competition and restrict monopoly practices.

concerted retail system A retail system in which a few retailers supply most of the market.

Confucian dynamism Theory that Confucian teachings affect attitudes toward time, persistence, ordering by status, protection of face, respect for tradition, and reciprocation of gifts and favors.

constant returns to specialization The units of resources required to produce a good are assumed to remain constant no matter where one is on a country's production possibility frontier.

contract Document that specifies conditions of an exchange and details rights and obligations of involved parties.

contract law Body of law that governs contract enforcement.

control systems Metrics used to measure performance of subunits.

controlling interest When a firm owns more than 50 percent of another business entity's voting stock.

Convention on Combating Bribery of Foreign Public Officials in International Business Transactions OECD agreement to make the bribery of foreign public officials a criminal offense.

copyright Exclusive legal rights of authors, composers, playwrights, artists, and publishers to publish and dispose of their work as they see fit.

core competence Firm skills that competitors cannot easily match or imitate.

corporate culture The organization's norms and value systems.

cost of capital Price of money.

Council of the European Union Group that represents the interests of EU members and has authority to approve EU laws.

counterpurchase A reciprocal buying agreement.

countertrade The trade of goods and services for other goods and services.

countervailing duties Antidumping duties.

country of origin effects A subset of source effects, or the extent to which the place of manufacturing influences product evaluations.

Court of Justice Supreme appeals court for EU law.

cross-cultural literacy Understanding how the culture of a country affects the way business is practiced.

cross-licensing agreement An arrangement in which a company licenses valuable intangible property to a foreign partner and receives a license for the partner's valuable knowledge; reduces risk of licensing.

cultural controls Achieving control by persuading subordinates to identify with the norms and value systems of the organization (self-control).

cultural relativism Belief that ethics are culturally determined, and a firm should adopt the ethics of the culture in which it is operating.

culture The complex whole that includes knowledge, belief, art, morals, law, custom, and other capabilities acquired by a person as a member of society.

currency board Means of controlling a country's currency.

currency crisis Occurs when a speculative attack on the exchange value of a currency results in a sharp depreciation in the value of the currency or forces authorities to expend large volumes of international currency reserves and sharply increase interest rates to defend the prevailing exchange rate.

currency speculation Involves short-term movement of funds from one currency to another in hopes of profiting from shifts in exchange rates.

currency swap Simultaneous purchase and sale of a given amount of foreign exchange for two different value dates.

currency translation Converting the financial statements of foreign subsidiaries into the currency of the home country.

current account In the balance of payments, records transactions involving the export or import of goods and services.

current account deficit The current account of the balance of payments is in deficit when a country imports more goods and services than it exports.

current account surplus The current account of the balance of payments is in surplus when a country exports more goods and services than it imports.

current cost accounting Method that adjusts all items in a financial statement to factor out the effects of inflation.

current rate method Using the exchange rate at the balance sheet date to translate the financial statements of a foreign subsidiary into the home currency.

customs union A group of countries committed to (1) removing all barriers to the free flow of goods and services between each other and (2) the pursuit of a common external trade policy.

D

D'Amato Act Act passed in 1996, similar to the Helms-Burton Act, aimed at Libya and Iran.

debt loan Requires a corporation to repay loan at regular intervals.

deferral principle Parent companies are not taxed on the income of a foreign subsidiary until they actually receive a dividend from that subsidiary.

democracy Political system in which government is by the people, exercised either directly or through elected representatives.

deregulation Removal of government restrictions concerning the conduct of a business.

diminishing returns to specialization Applied to international trade theory, the more of a good a country produces, the greater the units of resources required to produce each additional item.

dirty-float system A system under which a country's currency is nominally allowed to float freely against other currencies, but in which the government will intervene, buying and selling currency, if it believes that the currency has deviated too far from its fair value.

draft An order written by an exporter telling an importer what and when to pay.

drawee The party to whom a bill of lading is presented.

dumping Selling goods in a foreign market for less than their cost of production or below their "fair" market value.

E

eclectic paradigm Argument that combining location-specific assets or resource endowments and the firm's own unique assets often requires FDI; it requires the firm to establish production facilities where those foreign assets or resource endowments are located.

e-commerce Conducting business online through the Internet.

economic exposure The extent to which a firm's future international earning power is affected by changes in exchange rates.

economic risk The likelihood that events, including economic mismanagement, will cause drastic changes in a country's business environment that adversely affect the profit and other goals of a particular business enterprise.

economic union A group of countries committed to (1) removing all barriers to the free flow of goods, services, and factors of production between each other, (2) the adoption of a common currency, (3) the harmonization of tax rates, and (4) the pursuit of a common external trade policy.

economies of scale Cost advantages associated with large-scale production.

efficient market A market where prices reflect all available information.

elastic A small change in price produces a large change in demand.

ending rate The spot exchange rate when budget and performance are being compared.

equity loan Occurs when a corporation sells stock to an investor.

ethical dilemma Situation in which no available alternative seems ethically acceptable.

ethical strategy A course of action that does not violate business ethics.

ethical systems Cultural beliefs about what is proper behavior and conduct.

ethnocentric behavior Behavior that is based on the belief in the superiority of one's own ethnic group or culture; often shows disregard or contempt for the culture of other countries.

ethnocentric staffing A staffing approach within the MNE in which all key management positions are filled by parent-country nationals.

ethnocentrism Belief in the superiority of one's own ethnic group or culture.

eurobonds A bond placed in countries other than the one in whose currency the bond is denominated.

eurocurrency Any currency banked outside its country of origin.

Eurodollar Dollar banked outside the United States.

European Commission Responsible for proposing EU legislation, implementing it, and monitoring compliance.

European Council The heads of state of EU members and the president of the European Commission.

European Free Trade Association (EFTA) A free trade association including Norway, Iceland, and Switzerland.

European Monetary System (EMS) EU system designed to create a zone of monetary stability in Europe, control inflation, and coordinate exchange rate policies of EU countries.

European Parliament Elected EU body that provides consultation on issues proposed by European Commission.

European Union (EU) An economic group of 25 European nations. Established as a customs union, it is now moving toward economic union. (Formerly the European Community.)

exchange rate The rate at which one currency is converted into another.

exchange rate mechanism (ERM) Mechanism for aligning the exchange rates of EU currencies against each other.

exclusive channels A distribution channel that outsiders find difficult to access.

expatriate A citizen of one country working in another country.

expatriate failure The premature return of an expatriate manager to the home country.

expatriate manager A national of one country appointed to a management position in another country.

experience curve Systematic production cost reductions that occur over the life of a product.

experience curve pricing Aggressive pricing designed to increase volume and help the firm realize experience curve economies.

export management company Export specialists who act as an export marketing department for client firms.

Export–Import Bank (Eximbank) Agency of the U.S. government whose mission is to provide aid in financing and facilitate exports and imports.

exporting Sale of products produced in one country to residents of another country.

externalities Knowledge spillovers.

externally convertible currency Limitations on the ability of residents to convert domestic currency, though nonresidents can convert their holdings of domestic currency into foreign currency.

external stakeholders All other individuals and groups, other than internal stakeholders, that have some claim on the business.

F

factor endowments A country's endowment with resources such as land, labor, and capital.

factors of production Inputs into the productive process of a firm, including labor, management, land, capital, and technological know-how.

Financial Accounting Standards Board (FASB) The body that writes the generally accepted accounting principles by which the financial statements of U.S. firms must be prepared.

financial structure Mix of debt and equity used to finance a business.

first-mover advantages Advantages accruing to the first to enter a market.

first-mover disadvantages Disadvantages associated with entering a foreign market before other international businesses.

Fisher Effect Nominal interest rates (i) in each country equal the required real rate of interest (r) and the expected rate of inflation over the period of time for which the funds are to be lent (l). That is, $i\ r\ l$.

fixed exchange rates A system under which the exchange rate for converting one currency into another is fixed.

fixed-rate bond Offers a fixed set of cash payoffs each year until maturity, when the investor also receives the face value of the bond in cash.

flexible machine cells Flexible manufacturing technology in which a grouping of various machine types, a common materials handler, and a centralized cell controller produces a family of products.

flexible manufacturing technologies Manufacturing technologies designed to improve job scheduling, reduce setup time, and improve quality control.

floating exchange rates A system under which the exchange rate for converting one currency into another is continuously adjusted depending on the laws of supply and demand.

flow of foreign direct investment The amount of foreign direct investment undertaken over a given time period (normally one year).

folkways Routine conventions of everyday life.

foreign bonds Bonds sold outside the borrower's country and denominated in the currency of the country in which they are issued.

Foreign Corrupt Practices Act U.S. law regulating behavior regarding the conduct of international business in the taking of bribes and other unethical actions.

foreign debt crisis Situation in which a country cannot service its foreign debt obligations, whether private-sector or government debt.

foreign direct investment (FDI) Direct investment in business operations in a foreign country.

foreign exchange exposure The risk that future changes in a country's exchange rate will hurt the firm.

foreign exchange market A market for converting the currency of one country into that of another country.

foreign exchange risk The risk that changes in exchange rates will hurt the profitability of a business deal.

foreign portfolio investment (FPI) Investments by individuals, firms, or public bodies (e.g., national and local governments) in foreign financial instruments (e.g., government bonds, foreign stocks).

forward exchange When two parties agree to exchange currency and execute a deal at some specific date in the future.

forward exchange rate The exchange rates governing forward exchange transactions.

forward vertical FDI Investing in an industry abroad that sells outputs of domestic processes.

fragmented retail system A retail system in which there are many retailers, no one of which has a major share of the market.

franchising A specialized form of licensing in which the franchiser sells intangible property to the franchisee and insists on rules to conduct the business.

free trade The absence of barriers to the free flow of goods and services between countries.

free trade area A group of countries committed to removing all barriers to the free flow of goods and services between each other, but pursuing independent external trade policies.

freely convertible currency A country's currency is freely convertible when the government of that country allows both residents and nonresidents to purchase unlimited amounts of foreign currency with the domestic currency.

fronting loan A loan between a parent company and a foreign subsidiary that is channeled through a financial intermediary.

fundamental analysis Draws on economic theory to construct sophisticated econometric models for predicting exchange rate movements.

G

G20 Established in 1999, the G20 comprises the finance ministers and central bank governors of the 19 largest economies in the world, plus representatives from the European Union and the European Central Bank.

gains from trade The economic gains to a country from engaging in international trade.

General Agreement on Tariffs and Trade (GATT) International treaty that committed signatories to lowering barriers to the free flow of goods across national borders and led to the WTO.

geocentric staffing A staffing policy where the best people are sought for key jobs throughout an MNE, regardless of nationality.

global learning The flow of skills and product offerings from foreign subsidiary to home country and from foreign subsidiary to foreign subsidiary.

global matrix structure Horizontal differentiation proceeds along two dimensions: product divisions and areas.

global standardization strategy Strategy focusing on increasing profitability by reaping cost reductions from experience curve and location economies.

global web When different stages of the value chain are dispersed to those locations around the globe where value added is maximized or where costs of value creation are minimized.

globalization Trend away from distinct national economic units and toward one huge global market.

globalization of markets Moving away from an economic system in which national markets are distinct entities, isolated by trade barriers and barriers of distance, time, and culture, and toward a system in which national markets are merging into one global market.

globalization of production Trend by individual firms to disperse parts of their productive processes to different locations around the globe to take advantage of differences in cost and quality of factors of production.

gold par value The amount of currency needed to purchase one ounce of gold.

gold standard The practice of pegging currencies to gold and guaranteeing convertibility.

greenfield investment Establishing a new operation in a foreign country.

gross domestic product (GDP) The market value of a country's output attributable to factors of production located in the country's territory.

gross fixed capital formation Summarizes the total amount of capital invested in factories, stores, office buildings, and the like.

gross national income (GNI) Measures the total annual income received by residents of a nation.

gross national product (GNP) The market value of all the final goods and services produced by a national economy.

group An association of two or more individuals who have a shared sense of identity and who interact with each other in structured ways on the basis of a common set of expectations about each other's behavior.

H

Heckscher-Ohlin theory Countries will export those goods that make intensive use of locally abundant factors of production and import goods that make intensive use of locally scarce factors of production.

hedge fund Investment fund that not only buys financial assets (stocks, bonds, currencies) but also sells them short.

Helms-Burton Act Act passed in 1996 that allowed Americans to sue foreign firms that use Cuban property confiscated from them after the 1959 revolution.

historic cost principle Accounting principle founded on the assumption that the currency unit used to report financial results is not losing its value due to inflation.

home country The source country for foreign direct investment.

horizontal differentiation The division of the firm into subunits.

horizontal foreign direct investment Foreign direct investment in the same industry abroad as a firm operates in at home.

host country Recipient country of inward investment by a foreign firm.

Human Development Index An attempt by the United Nations to assess the impact of a number of factors on the quality of human life in a country.

human resource management Activities an organization conducts to use its human resources effectively.

I

import quota A direct restriction on the quantity of a good that can be imported into a country.

incentives Devices used to reward managerial behavior.

individualism An emphasis on the importance of guaranteeing individual freedom and self-expression.

individualism versus collectivism Theory focusing on the relationship between the individual and his or her fellows. In individualistic societies, the ties between individuals are loose and individual achievement is highly valued. In societies where collectivism is emphasized, ties between individuals are tight, people are born into collectives, such as extended families, and everyone is supposed to look after the interests of his or her collective.

inelastic When a large change in price produces only a small change in demand.

inefficient market One in which prices do not reflect all available information.

infant industry argument New industries in developing countries must be temporarily protected from international competition to help them reach a position where they can compete on world markets with the firms of developed nations.

inflows of FDI Flow of foreign direct investment into a country.

initial rate The spot exchange rate when a budget is adopted.

innovation Development of new products, processes, organizations, management practices, and strategies.

integrating mechanisms Mechanisms for achieving coordination between subunits within an organization.

intellectual property Products of the mind, ideas (e.g., books, music, computer software, designs, technological know-how). Intellectual property can be protected by patents, copyrights, and trademarks.

internal forward rate A company-generated forecast of future spot rates.

internal stakeholders Individuals or groups who work for or own the business.

internalization theory Marketing imperfection approach to foreign direct investment.

International Accounting Standards Board (IASB) Organization of representatives of professional accounting organizations from many countries that is attempting to harmonize accounting standards across countries.

international business Any firm that engages in international trade or investment.

international division Division responsible for a firm's international activities.

International Fisher Effect For any two countries, the spot exchange rate should change in an equal amount but in the opposite direction to the difference in nominal interest rates between countries.

International Monetary Fund (IMF) International institution set up to maintain order in the international monetary system.

international monetary system Institutional arrangements countries adopt to govern exchange rates.

international strategy Trying to create value by transferring core competencies to foreign markets where indigenous competitors lack those competencies.

international trade Occurs when a firm exports goods or services to consumers in another country.

ISO 9000 Certification process that requires certain quality standards that must be met.

J

joint venture A cooperative undertaking between two or more firms.

just distribution One that is considered fair and equitable.

just-in-time (JIT) Logistics systems designed to deliver parts to a production process as they are needed, not before.

K

Kantian ethics Belief that people should be treated as ends and never purely as means to the ends of others.

knowledge network Network for transmitting information within an organization that is based on informal contacts between managers within an enterprise and on distributed information systems.

L

lag strategy Delaying the collection of foreign currency receivables if that currency is expected to appreciate, and delaying payables if that currency is expected to depreciate.

late-mover advantages Benefits enjoyed by a company that is late to enter a new market, such as consumer familiarity with the product or knowledge gained about a market.

late-mover disadvantages Handicap that late entrants to a market suffer.

law of one price In competitive markets free of transportation costs and barriers to trade, identical products sold in different countries must sell for the same price when their price is expressed in the same currency.

lead market Market where products are first introduced.

lead strategy Collecting foreign currency receivables early when a foreign currency is expected to depreciate, and paying foreign currency payables before they are due when a currency is expected to appreciate.

lean production systems Flexible manufacturing technologies pioneered at Toyota and now used in much of the automobile industry.

learning effects Cost savings from learning by doing.

legal risk The likelihood that a trading partner will opportunistically break a contract or expropriate intellectual property rights.

legal system System of rules that regulate behavior and the processes by which the laws of a country are enforced and through which redress of grievances is obtained.

Leontief paradox The empirical finding that, in contrast to the predictions of the Heckscher-Ohlin theory, U.S. exports are less capital intensive than U.S. imports.

letter of credit Issued by a bank, indicating that the bank will make payments under specific circumstances.

licensing Occurs when a firm (the licensor) licenses the right to produce its product, use its production processes, or use its brand name or trademark to another firm (the licensee). In return for giving the licensee these rights, the licensor collects a royalty fee on every unit the licensee sells.

licensing agreement Arrangement in which a licensor grants the rights to intangible property to a licensee for a specified period and receives a royalty fee in return.

local content requirement A requirement that some specific fraction of a good be produced domestically.

localization strategy Plan focusing on increasing profitability by customizing the goods or services to match tastes in national markets.

location economies Cost advantages from performing a value creation activity at the optimal location for that activity.

location-specific advantages Advantages that arise from using resource endowments or assets that are tied to a particular foreign location and that a firm finds valuable to combine with its own unique assets (such as the firm's technological, marketing, or management know-how).

logistics The procurement and physical transmission of material through the supply chain, from suppliers to customers.

M

Maastricht Treaty Treaty agreed to in 1991, but not ratified until January 1, 1994, that committed the 12 member states of the European Community to a closer economic and political union.

make-or-buy decisions Decisions a company makes about whether to perform a value creation activity itself or outsource it to another entity.

maker Person or business initiating a bill of lading (draft).

managed-float system System under which some currencies are allowed to float freely, but the majority are either managed by government intervention or pegged to another currency.

management network A network of informal contact between individual managers.

market economy The allocation of resources is determined by the invisible hand of the price system.

market imperfections Imperfections in the operation of the market mechanism.

market makers Financial service companies that connect investors and borrowers, either directly or indirectly.

market power Ability of a firm to exercise control over industry prices or output.

market segmentation Identifying groups of consumers whose purchasing behavior differs from others in important ways.

marketing mix Choices about product attributes, distribution strategy, communication strategy, and pricing strategy that a firm offers its targeted markets.

masculinity versus femininity Theory of the relationship between gender and work roles. In masculine cultures, sex roles are sharply differentiated and traditional "masculine values" such as achievement and the effective exercise of

power determine cultural ideals. In feminine cultures, sex roles are less sharply distinguished, and little differentiation is made between men and women in the same job.

mass customization The production of a wide variety of end products at a unit cost that could once be achieved only through mass production of a standardized output.

materials management The activity that controls the transmission of physical materials through the value chain, from procurement through production and into distribution.

mercantilism An economic philosophy advocating that countries should simultaneously encourage exports and discourage imports.

MERCOSUR Pact between Argentina, Brazil, Paraguay, and Uruguay to establish a free trade area.

minimum efficient scale The level of output at which most plant-level scale economies are exhausted.

MITI Japan's Ministry of International Trade and Industry.

mixed economy Certain sectors of the economy are left to private ownership and free market mechanisms, while other sectors have significant government ownership and government planning.

money management Managing a firm's global cash resources efficiently.

Moore's Law The power of microprocessor technology doubles and its costs of production fall in half every 18 months.

moral hazard Arises when people behave recklessly because they know they will be saved if things go wrong.

mores Norms seen as central to the functioning of a society and to its social life.

multidomestic strategy Emphasizing the need to be responsive to the unique conditions prevailing in different national markets.

Multilateral Agreement on Investment (MAI) An agreement that would make it illegal for signatory states to discriminate against foreign investors; would have liberalized rules governing FDI between OECD states.

multilateral netting A technique used to reduce the number of transactions between subsidiaries of the firm, thereby reducing the total transaction costs arising from foreign exchange dealings and transfer fees.

multinational enterprise (MNE) A firm that owns business operations in more than one country.

multipoint competition Arises when two or more enterprises encounter each other in different regional markets, national markets, or industries.

multipoint pricing Occurs when a pricing strategy in one market may have an impact on a rival's pricing strategy in another market.

N

naive immoralist Approach that accepts ignoring ethical norms if others do so too.

new trade theory The observed pattern of trade in the world economy may be due in part to the ability of firms in a given market to capture first-mover advantages.

noise The amount of other messages competing for a potential consumer's attention.

nonconvertible currency A currency is not convertible when both residents and nonresidents are prohibited from converting their holdings of that currency into another currency.

norms Social rules and guidelines that prescribe appropriate behavior in particular situations.

North American Free Trade Agreement (NAFTA) Free trade area between Canada, Mexico, and the United States.

O

offset Agreement to purchase goods and services with a specified percentage of proceeds from an original sale in that country from any firm in the country.

offshore production FDI undertaken to serve the home market.

oligopoly An industry composed of a limited number of large firms.

optimal currency area Region in which similarities in economic activity make a single currency and exchange rate feasible instruments of macroeconomic policy.

organization culture Norms and values shared by employees.

Organization for Economic Cooperation and Development (OECD) A Paris-based intergovernmental organization of "wealthy" nations whose purpose is to provide its 29 member states with a forum in which governments can compare their experiences, discuss the problems they share, and seek solutions that can then be applied within their own national contexts.

organizational architecture Totality of a firm's organization.

organizational structure Determined by the formal division into subunits, the location of decision making, and the coordination of activities of subunits.

outflows of FDI Flow of foreign direct investment out of a country.

output controls Achieving control by setting goals for subordinates, expressing these goals in terms of objective criteria, and then judging performance by a subordinate's ability to meet these goals.

P

Paris Convention for the Protection of Industrial Property International agreement to protect intellectual property; signed by 96 countries.

patent Grants the inventor of a new product or process exclusive rights to the manufacture, use, or sale of that invention.

pegged exchange rate Currency value is fixed relative to a reference currency.

people Part of the organizational architecture that includes strategy used to recruit, compensate, and retain employees.

performance ambiguity Occurs when the causes of good or bad performance are not clearly identifiable.

personal controls Achieving control by personal contact with subordinates.

pioneering costs Costs an early entrant bears that later entrants avoid, such as the time and effort in learning the rules, failure due to ignorance, and the liability of being a foreigner.

political economy The study of how political factors influence the functioning of an economic system.

political risk The likelihood that political forces will cause drastic changes in a country's business environment that will adversely affect the profit and other goals of a particular business enterprise.

political system System of government in a nation.

political union A central political apparatus coordinates economic, social, and foreign policy.

polycentric staffing A staffing policy in an MNE in which host-country nationals are recruited to manage subsidiaries in their own country, while parent-country nationals occupy key positions at corporate headquarters.

positive-sum game A situation in which all countries can benefit even if some benefit more than others.

power distance Theory of how a society deals with the fact that people are unequal in physical and intellectual capabilities. High power distance cultures are found in countries that let inequalities grow over time into inequalities of power and wealth. Low power distance cultures are found in societies that try to play down such inequalities as much as possible.

predatory pricing Reducing prices below fair market value as a competitive weapon to drive weaker competitors out of the market ("fair" being cost plus some reasonable profit margin).

price discrimination The practice of charging different prices for the same product in different markets.

price elasticity of demand A measure of how responsive demand for a product is to changes in price.

private action Violation of property rights through theft, piracy, blackmail, and the like by private individuals or groups.

privatization The sale of state-owned enterprises to private investors.

processes Manner in which decisions are made and work is performed.

product liability Involves holding a firm and its officers responsible when a product causes injury, death, or damage.

product life-cycle theory The optimal location in the world to produce a product changes as the market for the product matures.

product safety laws Set certain safety standards to which a product must adhere.

production Activities involved in creating a product.

profit Difference between revenues and costs.

profit growth The percentage increase in net profits over time.

profitability A rate of return concept.

projected rate The spot exchange rate forecast for the end of the budget period.

property rights Bundle of legal rights over the use to which a resource is put and over the use made of any income that may be derived from that resource.

public action Violation of property rights when public officials extort income, resources, or the property itself from property holders.

pull strategy A marketing strategy emphasizing mass media advertising as opposed to personal selling.

purchasing power parity (PPP) An adjustment in gross domestic product per capita to reflect differences in the cost of living.

push strategy A marketing strategy emphasizing personal selling rather than mass media advertising.

Q

quota rent Extra profit producers make when supply is artificially limited by an import quota.

R

regional economic integration Agreements among countries in a geographic region to reduce and ultimately remove tariff and nontariff barriers to the free flow of goods, services, and factors of production between each other.

relatively efficient market One in which few impediments to international trade and investment exist.

religion A system of shared beliefs and rituals concerned with the sacred.

representative democracy A political system in which citizens periodically elect individuals to represent them in government.

righteous moralist Approach that one's own ethics are appropriate in all cultures.

rights theories Ethical approaches that recognize that humans have fundamental rights that transcend national boundaries.

right-wing totalitarianism A political system in which political power is monopolized by a party, group, or individual that generally permits individual economic freedom but restricts individual political freedom, including free speech, often on the grounds that it would lead to the rise of communism.

royalties Remuneration paid to the owners of technology, patents, or trade names for the use of same.

S

short selling Occurs when an investor places a speculative bet that the value of a financial asset will decline, and profits from that decline.

sight draft A draft payable on presentation to the drawee.

Single European Act A 1997 act, adopted by members of the European Community, that committed member countries to establishing an economic union.

Six Sigma Statistically based philosophy to reduce defects, boost productivity, eliminate waste, and cut costs.

Smoot-Hawley Act Enacted in 1930 by the U.S. Congress, this act erected a wall of tariff barriers against imports into the United States.

social democrats Those committed to achieving socialism by democratic means.

social mobility The extent to which individuals can move out of the social strata into which they are born.

social responsibility Concept that businesspeople should consider the social consequences of economic actions when making business decisions.

social strata Hierarchical social categories.

social structure The basic social organization of a society.

socialism A political philosophy advocating substantial public involvement, through government ownership, in the means of production and distribution.

society Group of people who share a common set of values and norms.

sogo shosha Japanese trading companies; a key part of the *keiretsu*, the large Japanese industrial groups.

source effects Effects that occur when the receiver of the message (i.e. a potential consumer) evaluates the message on the basis of status or image of the sender.

sourcing decisions Whether a firm should make or buy component parts.

specialized asset An asset designed to perform a specific task, whose value is significantly reduced in its next-best use.

specific tariff Tariff levied as a fixed charge for each unit of good imported.

spot exchange rate The exchange rate at which a foreign exchange dealer will convert one currency into another that particular day.

staffing policy Strategy concerned with selecting employees for particular jobs.

stakeholders Individuals or groups that have an interest, claim, or stake in the company, in what it does, and in how well it performs.

state-directed economy An economy in which the state plays a proactive role in influencing the direction and magnitude of private-sector investments.

stock of foreign direct investment The total accumulated value of foreign-owned assets at a given time.

strategic alliances Cooperative agreements between two or more firms.

strategic commitment A decision that has a long-term impact and is difficult to reverse, such as entering a foreign market on a large scale.

strategic pricing The concept containing the three aspects: predatory pricing, multipoint pricing, and experience curve pricing.

strategic trade policy Government policy aimed at improving the competitive position of a domestic industry and/or domestic firm in the world market.

strategy Actions managers take to attain the firm's goals.

Structural Impediments Initiative A 1990 agreement between the United States and Japan aimed at trying to decrease nontariff barriers restricting imports into Japan.

subsidy Government financial assistance to a domestic producer.

swaps The simultaneous purchase and sale of a given amount of foreign exchange for two different value dates.

switch trading Use of a specialized third-party trading house in a countertrade arrangement.

systematic risk Movements in a stock portfolio's value that are attributable to macroeconomic forces affecting all firms in an economy, rather than factors specific to an individual firm (unsystematic risk).

T

tariff A tax levied on imports.

tariff rate quota Lower tariff rates applied to imports within the quota than those over the quota.

tax credit Allows a firm to reduce the taxes paid to the home government by the amount of taxes paid to the foreign government.

tax haven A country with exceptionally low, or even no, income taxes.

tax treaty Agreement between two countries specifying what items of income will be taxed by the authorities of the country where the income is earned.

technical analysis Uses price and volume data to determine past trends, which are expected to continue into the future.

temporal method Translating assets valued in a foreign currency into the home currency using the exchange rate that existed when the assets were originally purchased.

theocratic law system A system of law based on religious teachings.

theocratic totalitarianism A political system in which political power is monopolized by a party, group, or individual that governs according to religious principles.

time draft A promise to pay by the accepting party at some future date.

time-based competition Competing on the basis of speed in responding to customer demands and developing new products.

timing of entry Entry is early when a firm enters a foreign market before other foreign firms and late when a firm enters after other international businesses have established themselves.

total quality management Management philosophy that takes as its central focus the need to improve the quality of a company's products and services.

totalitarianism Form of government in which one person or political party exercises absolute control over all spheres of human life and opposing political parties are prohibited.

trade creation Trade created due to regional economic integration; occurs when high-cost domestic producers are replaced by low-cost foreign producers within a free trade area.

trade deficit See **current account deficit.**

trade diversion Trade diverted due to regional economic integration; occurs when low-cost foreign suppliers outside a free trade area are replaced by higher-cost suppliers within a free trade area.

Trade Related Aspects of Intellectual Property Rights WTO agreement overseeing stricter intellectual property regulations.

trade surplus See **current account surplus.**

trademark Designs and names, often officially registered, by which merchants or manufacturers designate and differentiate their products.

transaction costs The costs of exchange.

transaction exposure The extent to which income from individual transactions is affected by fluctuations in foreign exchange values.

transfer fee A bank charge for moving cash from one location to another.

transfer price The price at which goods and services are transferred between subsidiary companies of a corporation.

translation exposure The extent to which the reported consolidated results and balance sheets of a corporation are affected by fluctuations in foreign exchange values.

transnational corporation A firm that tries to simultaneously realize gains from experience curve economies, location economies, and global learning, while remaining locally responsive.

transnational financial reporting The need for a firm headquartered in one country to report its results to citizens of another country.

transnational strategy Plan to exploit experience-based cost and location economies, transfer core competencies within the firm, and pay attention to local responsiveness.

Treaty of Lisbon A European Union–sanctioned treaty that will allow the European Parliament to become the co-equal legislator for almost all European laws. Ratification to be determined mid-2009.

Treaty of Rome The 1957 treaty that established the European Community.

tribal totalitarianism A political system in which a party, group, or individual that represents the interests of a particular tribe (ethnic group) monopolizes political power.

turnkey project A project in which a firm agrees to set up an operating plant for a foreign client and hand over the "key" when the plant is fully operational.

U

unbundling Relying on more than one financial technique to transfer funds across borders.

uncertainty avoidance Extent to which cultures socialize members to accept ambiguous situations and to tolerate uncertainty.

United Nations International institution with 191 member countries created to preserve peace.

United Nations Convention on Contracts for the International Sale of Goods (CIGS) Agreement establishing a uniform set of rules governing contracts between businesses in different nations.

Universal Declaration of Human Rights An agreement that establishes basic principles that should be adhered to irrespective of the culture.

universal needs Needs that are the same all over the world, such as steel, bulk chemicals, and industrial electronics.

utilitarian approach Ethical approach that holds that the moral worth of actions is determined by their consequences.

V

value creation Performing activities that increase the value of goods or services to consumers.

values Abstract ideas about what a society believes to be good, right, and desirable.

vehicle currency A currency that plays a central role in the foreign exchange market (e.g., the U.S. dollar and Japanese yen).

vertical differentiation The centralization and decentralization of decision-making responsibilities.

vertical foreign direct investment Foreign direct investment in an industry abroad that provides input into a firm's domestic operations, or foreign direct investment into an industry abroad that sells the outputs of a firm's domestic operations.

vertical integration Extension of a firm's activities into adjacent stages of productions (i.e., those providing the firm's inputs or those that purchase the firm's outputs).

voluntary export restraint (VER) A quota on trade imposed from the exporting country's side, instead of the importer's; usually imposed at the request of the importing country's government.

W

wholly owned subsidiary A subsidiary in which the firm owns 100 percent of the stock.

World Bank International institution set up to promote general economic development in the world's poorer nations.

World Intellectual Property Organization Group of 188 countries that have signed international treaties designed to protect intellectual property.

World Trade Organization (WTO) The organization that succeeded the General Agreement on Tariffs and Trade (GATT) as a result of the successful completion of the Uruguay round of GATT negotiations.

worldwide area structure Business organizational structure under which the world is divided into areas.

worldwide product division structure Business organizational structure based on product divisions that have worldwide responsibility.

Z

zero-sum game A situation in which an economic gain by one country results in an economic loss by another.

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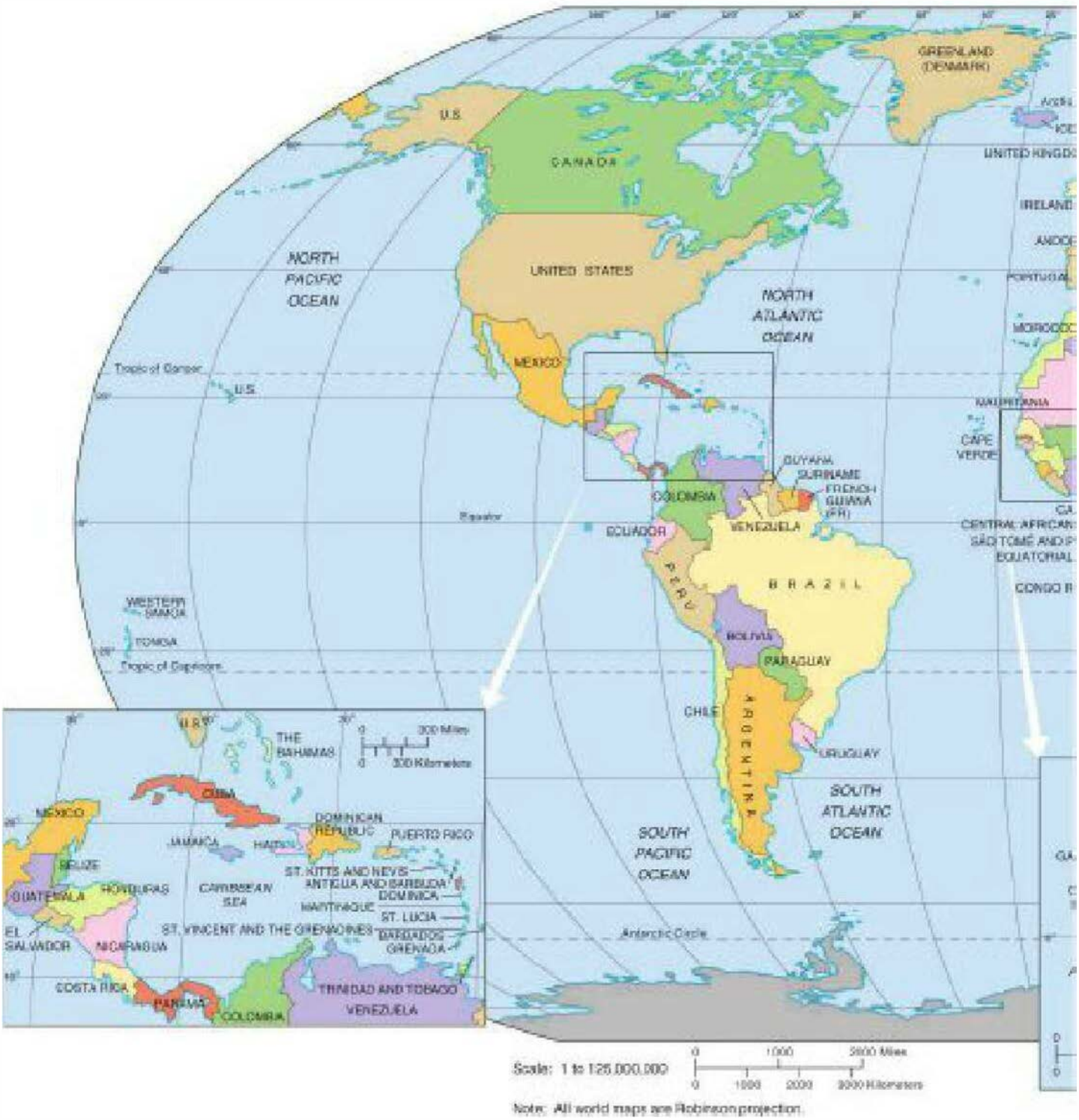

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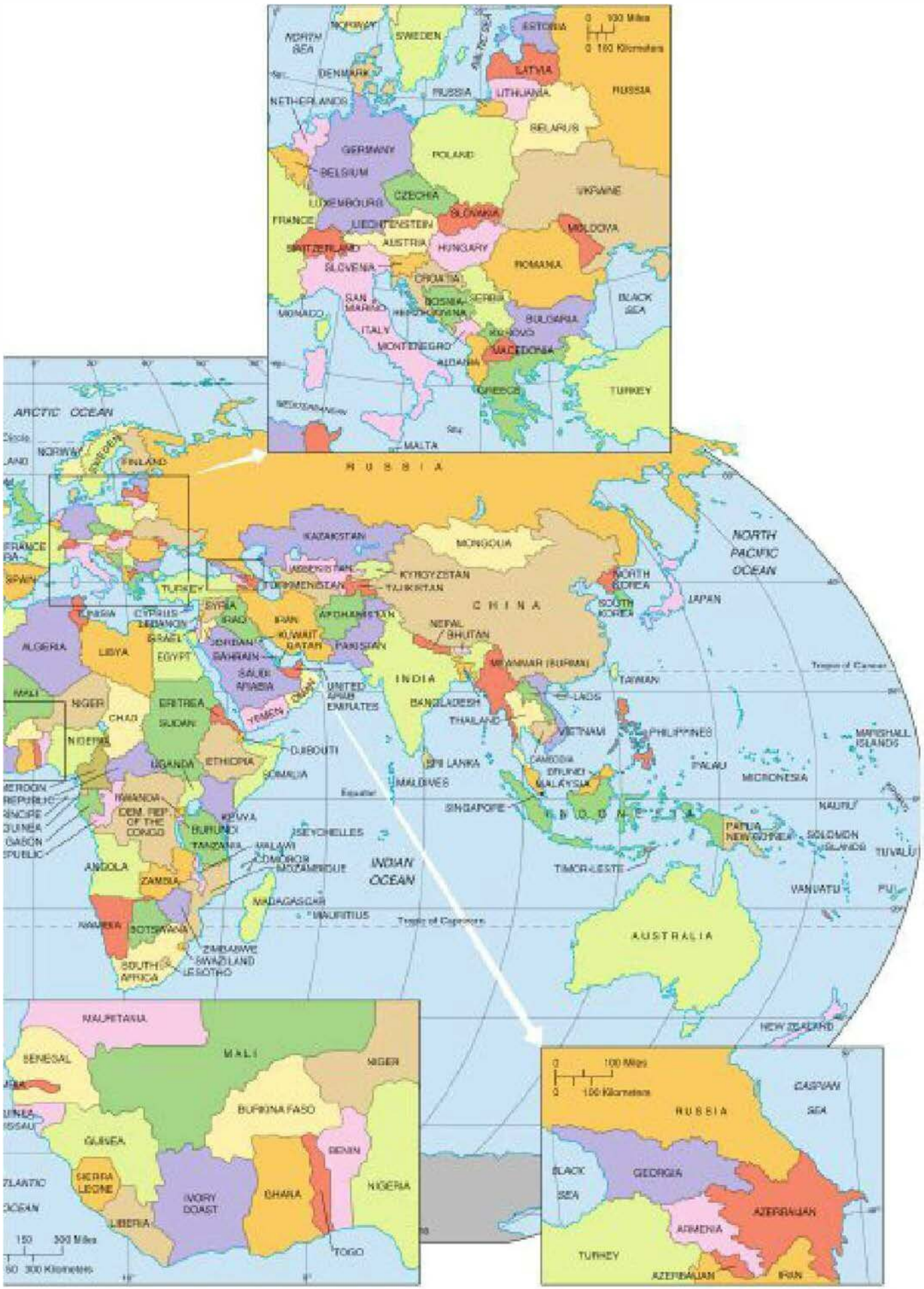
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