LOVELY PROFESSIONAL UNIVERSITY

INTERNATIONAL BUSINESS

Edited By

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SYLLABUS

International Business

Objectives: The objective of the course is to:

- Enable students build strong foundation in concepts of international trade and business
- Help students understand social, cultural and economic factors that lead to trade between countries
- Help students study various economic integrations for promoting regional trade and investments

Sr. No.	Topics
1	International Business: An Overview – Evolution of International Business, Drivers of Globalization, Influences of International Business, Stages of Internationalization, Differences between Domestic and International Business, International Business Approaches, Advantages of International Business.
2	Theories of International Trade – Mercantilism, Theory of absolute cost advantage, Comparative cost advantage theory, Relative factor endowment theory, Country similarity theory, Product life cycle theory.
3	International Business Environment – Social and Cultural Environment, Technological Environment, Economic Environment, Political Environment.
4	Modes of Entering International Business – Modes of Entry, Exporting, licensing, franchising, contract manufacturing, management contracts, turnkey projects, foreign direct investment, alliances like mergers and acquisitions, joint ventures, Comparison of Different Modes of Entry.
5	Foreign Direct Investment – Factors Influencing FDI, Reasons for FDI, Costs and Benefits of FDI, Trends in FDI, Foreign Direct Investment in India.
6	World Trade Organization – General Agreement on Tariffs and Trade (GATT), Establishment of World Trade Organization, The Uruguay Round Package: Organization Structure of the WTO, WTO – The Third Pillar in the Global Business.
7	International Financial Institutions and Liquidity – IMF, World Bank, International Development Association, International Liquidity and SDR International Finance Cooperation.
8	Basics of International Marketing, Basics of Global HRM, Basics of International Financial Management, Basics of International Accounting.
9	International Production and Logistics Management – Generic Strategies of the International Business, Acquisition of Resources, Location Decisions, International Logistics Management.
10	Global Strategic Management and Business Ethics – Peculiarities of Global Strategic Management, Value Creation, Global Strategic Management Process, Collaborative Strategies, Ethics and Global Business.

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Unit 1: International Business: An Overview

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Objectives

After studying this unit, you should be able to:

- Enumerate the concept of international business
- Analyse the evolution of international business
- Discuss the drivers of globalization
- Describe the stages of internationalization
- Explain the difference between domestic and international business
- Discuss the approaches of international business

Introduction

One of the most dramatic and significant world trends in the past two decades has been the rapid, sustained growth of international business. Markets have become truly global for most goods, many services, and especially for financial instruments of all types. World product trade has expanded by more than 6 percent a year since 1950, which is more than 50 percent faster than growth of output the most dramatic increase in globalization, has occurred in financial markets. In the global forex markets, billions of dollars are transacted each day, of which more than 90 percent represent financial transactions unrelated to trade or investment. Much of this activity takes place in the so-called Euromarkets, markets outside the country whose currency is used.

This pervasive growth in market interpenetration makes it increasingly difficult for any country to avoid substantial external impacts on its economy. In particular massive capital flows can push exchange rates away from levels that accurately reflect competitive relationships among nations if national economic policies or performances diverse in short run. The rapid dissemination rate of new technologies speeds the pace at which countries must adjust to external events. Smaller,

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more open countries, long ago gave up illusion of domestic policy autonomy. But even the largest and most apparently self-contained economies, including the US, are now significantly affected by the global economy. Global integration in trade, investment, and factor flows, technology, and communication has been tying economies together.

Why then are these changes coming about, and what exactly are they? It is in practice, easier to identify the former than interpret the latter. The reason is that during the past few decades, the emergence of corporate empires in the world economy, based on the contemporary scientific and technological developments, has led to globalization of production. As a result of international production, co-operation among global productive units, the large-scale capital exports, "the export of production" or "production abroad" has come into prominence as against commodity export in world economy in recent years. Global corporations consider the whole of the world their production place, as well as their market and move factors of production to wherever they can optimally be combined. They avail fully of the revolution that has brought about instant worldwide communication, and near instant-transformation. Their ownership is transnational; their management is transnational. Their freely mobile management, technology and capital, the modern agent for stepped-up economic growth, transcend individual national boundaries. They are domestic in every place, foreign in none-a true corporate citizen of the world. The greater interdependence among nations has already reduced economic insularity of the peoples of the world, as well as their social and political insularity.

International business includes any type of business activity that crosses national borders. Though a number of definitions in the business literature can be found but no simple or universally accepted definition exists for the term international business. At one end of the definitional spectrum, international business is defined as organization that buys and/or sells goods and services across two or more national boundaries, even if management is located in a single country. At the other end of the spectrum, international business is equated only with those big enterprises, which have operating units outside their own country. In the middle are institutional arrangements that provide for some managerial direction of economic activity taking place abroad but stop short of controlling ownership of the business carrying on the activity.

Example: Joint ventures with locally owned business or with foreign governments.

In its traditional form of international trade and finance as well as its newest form of multinational business operations, international business has become massive in scale and has come to exercise a major influence over political, economic and social from many types of comparative business studies and from knowledge of many aspects of foreign business operations. In fact, sometimes the foreign operations and the comparative business are used as synonymous for international business. Foreign business refers to domestic operations within a foreign country. Comparative business focuses on similarities and differences among countries and business systems for focuses on similarities and differences among countries and business operations and comparative business as fields of enquiry do not have as their major point of interest the special problems that arise when business activities cross national boundaries.

Example: The vital question of potential conflicts between the nation-state and the multinational firm, which receives major attention is international business, is not like to be centered or even peripheral in foreign operations and comparative business.

1.1 Evolution of International Business

The business across the borders of the countries had been carried on since times immemorial. But, the business had been limited to the international trade until the recent past. The post-World War II period witnessed an unexpected expansion of national companies into international or multinational companies. The post 1990's period has given greater fillip to international business.

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In fact, the term international business was not in existence before two decades. The term 'international business' has emerged from the term 'international marketing', which, in turn, emerged from the term 'export marketing'.

International Trade to International Marketing: Originally, the producers used to export their products to the nearby countries and gradually extended the exports to far-off countries. Gradually, the companies extended the operations beyond trade.

Example: India used to export raw cotton, raw jute and iron ore during the early 1900s. The massive industrialization in the country enabled us to export jute products, cotton garments and steel during 1960s.

India, during 1980s could create markets for its products, in addition to mere exporting. The export marketing efforts include creation of demand for Indian products like textiles, electronics, leather products, tea, coffee etc., arranging for appropriate distribution channels, attractive package, product development, pricing etc. This process is true not only with India, but also with almost all developed and developing economies.

International Marketing to International Business: The multinational companies which were producing the products in their home countries and marketing them in various foreign countries before 1980s started locating their plants and other manufacturing facilities in foreign/host countries. Later, they started producing in one foreign country and marketing in other foreign countries.

Example: Unilever established its subsidiary company in India, i.e., Hindustan Lever Limited (HLL), HLL produces its products in India and markets them in Bangladesh, Sri Lanka, and Nepal etc. Thus, the scope of the international trade is expanded into international marketing and international marketing is expanded into international business.

History of international business starts with the evolution of human civilization. The integration and growth of economies and societies was the main reason for the first phase of international business and globalization.

Timeline

- 19th Century: Broader concept of the integration of economies and societies
- 1870: Began first phase of Globalization
- 1919: World War II: End of first phase of Globalization, Industrial revolution in UK, Germany and the USA Sharp increase in the trade with import and export by colonial empires
- 1913: GDP 22.1: After 1913: Increased Trade Barriers to Protect Domestic Production
- 1930's: Declined Trade Ratio, GDP 9.1
- After 1930's: World Nations felt the need for International Cooperation in global trade and balance of payments affairs
- Establishment of IMF and IBRD (World Bank)
- IMF: International Monetary Fund
- IBRD: International Bank for Reconstruction and Development
- 1947: 23 countries conducted negotiations in order to prevent the protectionist policies and to revive the economies from recession aiming at establishment of World Trade organization

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- 1947: Establishment of GATT (General Agreement on Trade and Tariffs)
- 1980s: efforts to convert GATT into WTO
- 1st Jan 1995: GATT was replaced by WTO (World Trade Organization)
- Trade Liberalization
- 1990 – 2000: The Term IB (International Business) has emerged from the term International Marketing.

  There are two Phases of the evolution of the term International Business

  1. International Trade to International Marketing
  2. International Marketing to International Business
- After 1990: Rapid Internationalization ad globalization

Today: Interpreting the PESTIN factors of International Trade environment more clearly.

Did u know? After 1930's, the world felt the need for international cooperation in global trade, so for this reason IMF and IBRO were established.

1.2 Drivers of Globalization

We have discussed the nature of international business and the precautions that the multinational companies should take while operating in foreign countries. The basic question of "why do the businesses firms of a country go to other countries?" might have been in your minds. Therefore, the answer to this question, before proceeding further:

To Achieve Higher Rate of Profits: As we have discussed in various courses/subjects like Principles and Practice of Management, Managerial Economics and Financial Management That the basic Objective of the business firms is to earn profits, business firms search for foreign markets which promise for higher rate of profits. For example, Hewlett Packard earned 85.4% of its profits from the foreign markets compared to that of domestic markets in 1994. Apple earned US$390 million as net profit from the foreign markets and only US $310 millions as net profit from its domestic market in 1994.

Expanding the Production Capacities Beyond the Demand of the Domestic Country: Some of the domestic companies expanded their production capacities more than the demand for the product in the domestic countries. These companies, in such cases, are forced to sell their excess production in foreign developed countries. Toyota of Japan is an example.

Severe Competition in the Home Country: The countries oriented towards market economies since 1960s had severe competition from other business firms in the home countries. The weak companies which could not meet the competition of the strong companies in the domestic country started entering the markets of the developing countries.

Limited Home Market: When the size of the home market is limited either due to the smaller size of the population or due to lower purchasing power of the people or both, the companies internationalize their operations.

Example: Most of the Japanese automobile and electronic firms entered US, Europe and even African markets due to the smaller size of the home market. ITC entered the European market due to the lower purchasing power of the Indians with regard to high quality cigarettes. Similarly, the mere six million population of Switzerland is the reason for Ciba-Geigy to internationalize its operations. In fact, this company was forced to concentrate on global market and establish manufacturing facilities in foreign countries.

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Political Stability vs. Political Instability: Political stability does not simply mean that continuation of the same party in power, but it does mean that continuation of the same policies of the Government for a quite longer period. It is viewed that USA is a politically stable country. Similarly, UK, France, Germany, Italy and Japan are also politically stable countries. Most of the African countries and some of the Asian countries like Malaysia, Indonesia, Pakistan and India are politically instable countries. In fact, business firms shift their operations from politically instable countries into politically stable countries.

Availability of Technology and Managerial Competence: Availability of advanced technology and managerial competence in some countries act as pulling factors business firms from home country. Companies from the developing world are attracted by the developed countries due to these reasons. In fact, American Companies, in recent years, depend on Japanese companies for technology and management expertise.

The drivers of globalization can be classified into.

1. ***Market Drivers:***
   - (a) Per capita income converging among industrialized nations
   - (b) Convergence of lifestyles and tastes
   - (c) Organizations beginning to behave as global consumers
   - (d) Increasing travel create global consumers
   - (e) Growth of global and regional channels
   - (f) Establishment of world brands
   - (g) Push to develop global advertising
2. ***Cost Drivers:***
   - (a) Continuing push for economies of scale
   - (b) Accelerating technological innovation
   - (c) Advances in transportation
   - (d) Emergence of newly industrialized countries with productive capability and low labour costs
   - (e) Increasing cost of product development relative to market life
3. ***Government Drivers:***
   - (a) Reduction of tariff barriers
   - (b) Reduction of non-tariff barriers
   - (c) Creation of blocs
   - (d) Decline in role of governments as producers and consumers
   - (e) Privatization in previously state-dominated economies
   - (f) Shift to open market economies from closed communist systems in eastern Europe
4. ***Competitive Drivers:***
   - (a) Continuing increases in the level of world trade
   - (b) Increased ownership of corporations by foreign acquirers
   - (c) Rise of new competitors' intent upon becoming global competitors

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(d) Growth of global networks making countries interdependent in particular industries

(e) More companies becoming globally centered rather than nationally centered

(f) Increased formation of global strategic alliances

5. *Other Drivers:*

(a) Revolution in information and communication

(b) Globalization of financial markets

(c) Improvements in business travel

Self Assessment

Fill in the blanks:

1. The countries oriented towards market economies since ..... had severe competition from other business firms in the home countries.
2. ..... stability does not simply mean that continuation of the same party in power, but it does mean that continuation of the same policies of the Government for a quite longer period.
3. History of international business ..... with the evolution of human civilization.
4. International ..... includes any type of business activity that crosses national borders.
5. India, during ..... could create markets for its products, in addition to mere exporting.

1.3 Influences of International Business

Because most of the countries are not as fortunate as the India in terms of market size, resources, and opportunities, they must trade with others to survive; Hong Kong, has historically underscored this point well, for without food and water from china proper, the British colony would not have survived along. The countries of Europe have had similar experience, since most European nations are relatively small in size. Without foreign markets, European firms would not have sufficient economies of scale to allow them to be competitive with US firms. Nestle mentions in one of its advertisements that its own country, Switzerland, lacks natural resources, forcing it to depend on trade and adopt the geocentric perspective. International competition may not be matter of choice when survival is at stake. However, only firms with previously substantial market share and international experience could expand successfully.

Growth of Overseas Markets

Developing countries, in spite of economic and marketing problems, are excellent markets. According to a report prepared for the U.S. CONGRESS by the U.S. trade representative, Latin America and Asia/Pacific are experiencing the strongest economic growth. American markets cannot ignore the vast potential of international markets. The world is more than four times larger than the U.S. market. In the case of Amway corps., a privately held U.S. manufacturer of cosmetics, soaps and vitamins, Japan represents a larger market than the India.

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Sales and Profit

Foreign markets constitute a larger share of the total business of many firms that have wisely cultivated markets aboard. Many large U.S. companies have done well because of their overseas customers. IBM and Compaq, foe ex, sell more computers aboard than at home. According to the US dept. of commerce, foreign profits of American firms rose at a compound annual rate of 10% between 1982 and 1991, almost twice as fast as domestic profits of the same companies.

Diversification

Demand for mast products is affected by such cyclical factors as recession and such seasonal factors as climate. The unfortunate consequence of these variables is sales fluctuation, which can frequently be substantial enough to cause lay offs of personnel. One way to diversify a companies' risk is to consider foreign markets as a solution for variable demand. Cold weather, for instance may depress soft drink consumption. Yet not all countries enter the winter season at the same time, and some countries are relatively warm year round. Bird, USA, inc., a Nebraska manufacturer of go carts, and mini cars, for promotional purposes has found that global selling has enabled the company to have year round production. It may be winter in Nebraska but its summer in the southern hemisphere – somewhere there is a demand and that stabilizes the business.

Inflation and Price Moderation

The benefits of export are readily self-evident. Imports can also be highly beneficial to a country because they constitute reserve capacity for the local economy. Without imports, there is no incentive for domestic firms to moderate their prices. The lack of imported product alternatives forces consumers to pay more, resulting in inflation and excessive profits for local firms. This development usually acts as prelude to workers demand for higher wages, further exacerbating the problem of inflation.

Import quotas imposed on Japanese automobiles in the 1980's saved 46200 US production jobs but at a cost of $160,000 per job per year. This cost was a result of the addition of $400 to the prices of US cars, and $1000 to the prices of Japanese imports. This windfall for Detroit resulted in record high profits for US automakers. Not only do trade restrictions depress price competition in the short run, but they also can adversely affect demand for year to come.

Caution Demand for most products is easily to be fluctuated by occurrence of any cyclical or seasonal factors pertaining like recession or climate.

Employment

Trade restrictions, such as high tariffs caused by the 1930's Smoot-Hawley bill, which forced the average tariff rates across the board to climb above 60%, contributed significantly to the great depression and have the potential to cause wide spread unemployment again. Unrestricted trade on the other hand improves the world's GNP and enhances employment generally for all nations. Importing products and foreign ownership can provide benefits to a nation. According to the institute for international economics – a private, non-profit research institute – the growth of foreign ownership has not resulted in a loss of jobs for Americans; and foreign firms have paid their American workers the same, as have domestic firms.

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Standards of Living

Trade affords countries and their citizen's higher standards of living than other wise possible. Without trade, product shortages force people to pay more for less, products taken for granted, such as coffee and bananas may become unavailable overnight. Life in most countries would be much more difficult were it not for the many strategic metals that must be imported. Trade also makes it easier for industries to specialize and gain access to raw materials, while at the same time fostering competition and efficiency. A diffusion of innovations across national boundaries is useful by-products of international trade. A lack of such trade would inhibit the flow innovative ideas.

The 1990s and the new millennium clearly indicate rapid internationalization and globalization. The entire globe is passing at a dramatic pace through the transition period. Today the international trader is in a position to analyze and interpret the global social, technical, economic, political and natural environmental factors more clearly.

Conducting and managing international business operations is a crucial venture due to variations in political, social, cultural and economic factors, from one country to another country.

Example: Most of the African consumers prefer high quality and high priced products due to there higher ability to buy.

Therefore, the international businessman should produce and export less costly products to most of the African countries and *vice versa* to most of the European and North American countries. High priced Palmolive soaps are exported and marketed in developing countries like Ethiopia, Pakistan, Kenya, India, Cambodia etc.

International business houses need accurate information to make an appropriate decision. Europe was the most opportunistic market for leather goods and particularly for shoes. Bata based on the accurate data could make appropriate decision to enter various European countries.

International business houses need not only accurate but timely information. Coca-Cola could enter the European market based on the timely information, whereas Pepsi entered later.

Another example is the timely entrance of Indian Software companies also made timely decision in the case of Europe.

The size of the international business should be large in order to have impact on the foreign economies. Most of the multinational companies are significantly large in size. In fact, the capital of some of the MNCs is more than our annual budget and GDPs of the some of the African countries.

Most of the international business houses segment their markets based on the geographic market segmentation. Daewoo segmented its market as North America, Europe, Africa, India sub-continent and Pacific market.

International markets present more potentials than the domestic markets. This is due to the fact that international markets are wide in scope, varied in consumer tastes, preferences and purchasing abilities, size of the population etc.

Example: IBM's sales are more in foreign countries than in USA. Similarly, Coca-Cola sales, Procter and Gamble's sales and Satyam Computer's Sales are more in foreign countries than in their respective home countries.

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Self Assessment

Fill in the blanks:

6. ..... diagnosis consists of managerial decisions made by analyzing the significance of the data (opportunities and threats) of the environmental analysis.
7. International business includes any type of business activity that crosses ..... borders.
8. The ..... of the international business should be large in order to have impact on the foreign economies.
9. International business ..... need accurate information to make an appropriate decision.
10. ..... markets present more potentials than the domestic markets.

1.4 Stages of Internationalization

Internationalization process for a company is a complex process. The experts have discussed various strategies that are generally adopted in the process of internationalization. The optimal strategic attractive available to firms depend upon different levels of internationalization. Although there are variations in how international operations evolve, some overall patterns have been noted. Most of these patterns relate to risk minimization behaviour. In other words, most companies view foreign operations as riskier than domestic ones because they must operate in environments which are less familiar to them. Thus, they initially undertake international activities reluctantly and follow practices to minimize their risks. But as they learn more about foreign operations and experience success with them, they move to deeper foreign commitments that now seem less risky to them.

Patterns of Expansion

The farther a company moves from the center on any axis, the deeper its international commitment becomes. However, a company does not necessarily move at the same speed along each axis. A slow movement along one axis may free up resources that allow faster expansion along another.

For example, a company may lack initial capacity to own facilities wholly in multiple foreign countries; thus it may choose either to limit its foreign capital commitment by moving slowly along axis C in order to move rapidly along axis D (to multiple foreign countries), or *vice versa*.

1. ***Passive to Active Expansion – Path A:*** The impetus of strategic focus is shown on axis A in Figure 1.1. Most new companies are established in response to observed domestic needs, and they frequently think only of domestic opportunities until a foreign opportunity is presented to them.

   For example, companies commonly receive unsolicited export rejects because someone has already seen or heard of their products. Often these companies have no idea of how their products became known abroad.

   But at this juncture, they must make a decision to export or not. Many decide not to because they fear they will not be paid or they know too little about the mechanics of foreign trade. Those that do fulfill the unsolicited export orders and then see that opportunities are available to them abroad are apt later to seek out other markets to sell their goods. Even large companies may move from passive to active involvement with aspects of their business.

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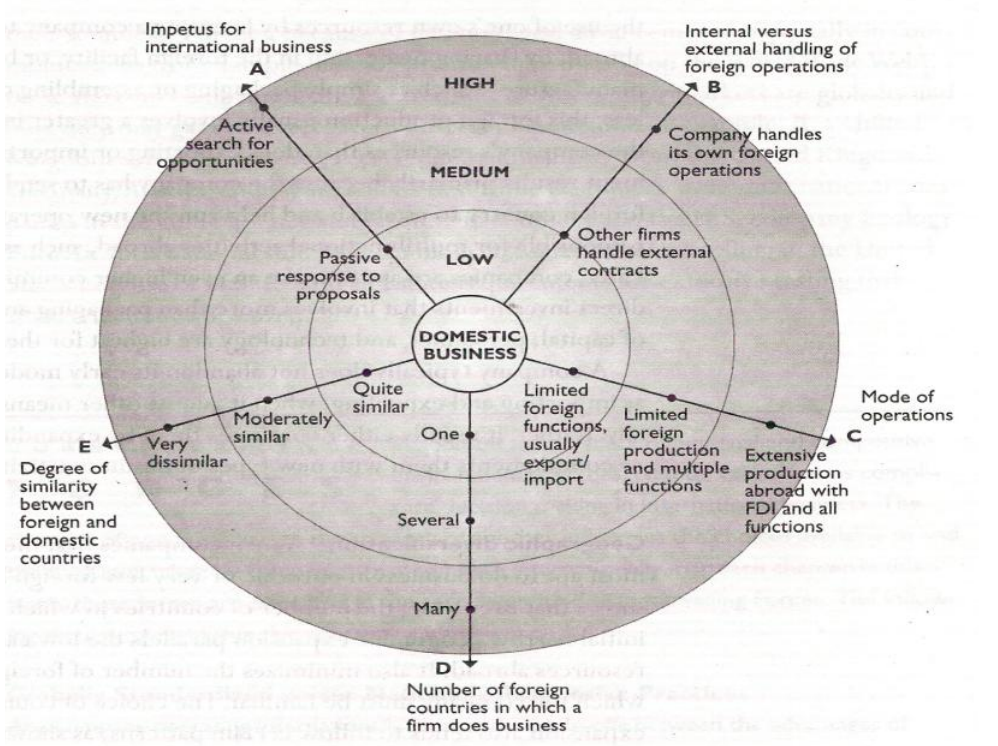
For example, although Tokyo Disneyland was proposed by a group of Japanese businessmen, the success of that venture led Disney to actively seek out a European location or another park.

2. ***External to Internal Handling of Operations – Path B:*** The use of intermediaries to handle foreign operations is common during early stage of international expansion because this method may minimize risk of committing one's own resources to international endeavours and also because of reliance on another company that already knows how to operate in foreign environments.

   But if the business grows successfully, the company will usually be more willing to handle the operations with its own staff. This is because it has learned more about foreign operations, sees them as being less risky than at the onset, and realizes the volume of business justifies the development of internal capabilities by hiring additional trained personnel, for purposes such as to maintain a department to carry out foreign sales or purchases. This evolution is shown on axis B in Figure 1.1.

Figure 1.1: The Usual Patterns of Internationalization



3. ***Deepening Mode of Commitment – Path C:*** Axis C in Figure 1.1 shows that importing or exporting is usually the first type of foreign operation a company undertakes. At an early stage of international involvement, importing or exporting requires the least commitment and the least risk to the company's resources such as capital, personnel, equipment, and production facilities.

   For example, a company could engage in exporting by using excess production capacity to produce more goods which then would be exported. By doing this, it would limit its need to invest more capital in additional production facilities such as plants and machinery. Further, the engagement of only importing and exporting limits the functions with which the company is responsible abroad.

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For example, it does not have to manage a foreign work force.

Companies often move into some type of foreign production after successfully building exports to that market. Initially this foreign production is apt to minimize the use of one's own resources by licensing, by sharing ownership in the foreign facility, or by limiting the amount of manufacture such as simply packaging or assembling output abroad.

Nevertheless this foreign production usually involves a greater international commitment of the company's resources than does exporting to importing. The greater commitment results primarily because the company has to send qualified technicians to the foreign country to establish and help run the new operations. Further, it must be responsible for multifunctional activities abroad, such as sales and production. Later, companies are apt to make an even higher commitment through foreign direct investments that involves more than packaging and assembly. Their infusion of capital, personnel, and technology are highest for these operations. A company typically does not abandon its early modes of operating abroad, such as importing and exporting, when it adopts other means of operating internationally. Rather, it usually continues them by expanding its trade to new market or complements them with new types of business activities.

4. ***Geographic Diversification – Path D:*** When companies first move internationally, they have one or very few foreign locations. Axis D in Figure l.1 shows that overtime, the number of countries in which they operate increases. The initial narrow geographic expansion parallels the low early commitment of resources abroad. It also minimizes the number of foreign environments with which the company must be familiar.

   Initially, companies tend to go to those locations that are geographically close and/or perceived to be similar. There is also a perception of less risk because of greater familiarity with nearby areas and because of a perception of similarity of environments because of common languages and levels of economic development. Later, companies move to more distant countries, including those that are perceived to have less similar environments to those found in home country.

5. ***Leapfrogging of Expansion – Path E:*** The patterns that most companies have followed in their international expansion are not necessarily optimal for their long range performance.

Example: The initial movement into a nearby country, like movement by a US company into Canada, may delay entry into faster growing markets, such as some of those in Southeast Asia. There is, however, evidence that many new companies are starting out with a global focus.

Normally the following stages of internationalization can be followed as:

Stage 1 – Domestic Company: Domestic Company limits its operations, mission and vision to the national political boundaries. These companies focus its view on the domestic market opportunities, domestic suppliers, domestic financial companies, domestic customers etc. These companies analyze the national environment of the country, formulate the strategies to exploit the opportunities offered by the environment.

Stage 2 – International Company: These companies select the strategy of locating the branch in the foreign market and extend the same domestic operations into foreign markets. These companies remain ethnocentric or domestic country oriented. Normally internalization process of most of the global companies starts with this stage of two processes. Many of the companies follow this strategy due to limited resources and also to learn from the foreign market gradually before becoming a global company without much risk.

Stage 3 – Multinational Company: This stage of multinational company is also referred as multidomestic company formulates different strategies for different market, thus the orientation shift from ethnocentric to polycentric. Under polycentric orientation the offices/branches/

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subsidiaries of a MNC work like a domestic company in each country where they operate with distinct policies and strategies suitable to that country concerned.

Stage 4 – Global Company: Global company is the one which has either produces in home country or in a single country and focuses on marketing these products globally and focuses on marketing these products domestically.

Stage 5 – Transnational Company: Transnational company produces, market, invests and operate across the world. It is an integrated global enterprise which links global resources with global market at profits. There is no such pure transnational corporation.

Characteristics of a Transnational Company

This company thinks globally and acts locally. This company adopts global strategy but allow value addition to the customer of a domestic country. The assets of a transnational company are distributed throughout the world, independent and specialized. The R&D facilities of a transnational company are spread in many countries.

- ***Scanning or Information Acquisition:*** These companies scan the environmental information regarding economic, political, social and cultural and technological environment. These companies collect and scan the information regardless geographical and national boundaries.
- ***Vision and Aspiration*** are global, global markets, global customers, and grow ahead of other global/transnational companies.
- ***Geographical Scope:*** They analyze the global opportunities regarding the availability of resources, customers, markets, technology, research and development etc. The scope is not limited to certain countries in analyzing opportunities, threat and formulating strategies.
- ***Adaptation:*** Global and Transnational companies Adapt their products, marketing strategies and other functional strategies to the environmental factor of the market concerned.

Example: Mercedes Benz is a super luxury car in North America, luxury in Germany and standard taxi in Europe.

- ***Extension:*** Some products do not require any change when they are marketed in other countries. Their market is just extension.

Example: Transnational companies create their global brand extending the product to the new market. Rothmans cigarette extended its products in many Europeans and African countries.

- ***HRM policy:*** It selects the best human resource and develops them regardless nationality, ethnic group.
- ***Purchasing:*** Transnational company procures world class material from the best source across the globe.

Caselet

India to Allow FDI in Food Retail

Indian government is considering allowing Foreign Direct Investment (FDI) in food retail. The Ratan Tata led Investment Commission has favoured permitting FDI in food retail, especially fresh and processed fruit and vegetables, with export commitments.

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According to Food Processing Minister Subodh Kant Sahay, *"It should be done in such a way that it would boost our agriculture. Our farmers must also get benefits of economic liberalization"*.

The Investment Commission, set up by the Prime Minister in 2004 to boost investments, made recommendations to the government on both policies and procedures to facilitate greater FDI inflows. The report said, "Foreign food retailers could help in the transmission and adoption of better practices throughout the supply chain and could also facilitate access to export markets."

Agreeing with the panel's suggestion, Mr. Sahay said "there was a need to bring market discipline in procuring agro products from farms. FDI in food retail is the need of the hour. It would mean use of latest technology in the sector, more yield per hectare and optimum usage of arable land. Allowing FDI will create demand across all levels, from raw material to finished products, and, at the same time, maintaining every level of quality and standards."

After permitting 51 percent FDI in single-brand retailing, allowing FDI in select food items, fresh and processed fruit and vegetables is the next step. It would include retailing of farm and dairy produce, marine and poultry products, besides fruit and vegetables. While 100 percent FDI is allowed in food processing, investment is restricted in retailing.

Today, barely 6 percent of fruit and vegetables produced in India are processed. The country has targeted 20 percent processing within the next few years and is keen on enhancing export of these items from less than 1-3 percent. The government was also considering opening up the $330 billion retail market with adequate provisions to protect neighbourhood stores. The commerce department is waiting for the report being prepared by ICRIER on the impact of retail on local Kirana outlets. The study was commissioned to the Delhi-based think-tank after the Congress party voiced its concerns over the effects of FDI on retail in the unorganized sector.

Source: The Economic Times (ET), April 22, 2008.

1.5 Differences between Domestic and International Business

Difference between domestic trade and foreign trade and their peculiar problems. Trade, no doubt, implies exchange of goods between persons, but there are marked differences between domestic trade and international trade. The differences and the complications arise therein are as follows:

1. ***Distance:*** The distance involved in export of goods in external trade is generally greater than on the domestic trade.
2. ***Language differences:*** There are differences in the languages of the nations of the world. The overseas traders should be very careful in preparing the publicity material in the languages of the trading country.
3. ***Cultural difference:*** A producer should have full knowledge about the market of his products. For exporting goods particularly a thorough research is undertaken.
4. ***Technical difference:*** In the national market the difference in the technical specification for goods and their requirements is not wide.
5. ***Tariff barriers:*** In the national trade, there are no custom duties, exchange restrictions, fixed quotas or other tariff barriers.
6. ***Documentations:*** In the home trade there are few documents involved in the exchange of goods.

Notes

7. ***Payments:*** In the internal trade, the goods are exchanged in the currency unit of the country. In case of foreign trade currencies differ widely throughout the world and those also vary in value.

8. ***Transport and insurance cost:*** The transport and insurance costs are less in case of domestic trade. For the exports, on the other hand the cost of transport is high and the insurance is complicated.

Notes Global Company is the one which has either produces in home country or in a single country and focuses on marketing these products globally and focuses on marketing these products domestically.

Task Expenses an transport will be higher international trader or domestic trader.

1.6 International Business Approaches

In truth, we have become part of a global village and have a global economy where no organization is insulted from the effects foreign markets and competition. Indeed, more and more firm are reshaping themselves for international competition and discovering new ways to exploit markets in every corner of the world. Failure to take a global perspective in one of the biggest mistakes managers can make. Thus we start laying the foundation for our discussion by introducing and describing the basic of international business.

An international business is one that is based primarily in a single country but acquires some meaningful share of its resources or revenues (or both) from other countries. Sears fits this description. Most of its stores are in the United States.

Example: The retailer earns around 90 percent of its revenues from its U. S. operation with the remaining 10 percent coming sears stores in Canada. At the same time, however, many of the products it sells, such as tools and clothing are made abroad from any perspective. Then it is clear that we live in a truly global economy. Virtually all business today must be concerned with the competitive situations they face in lands for from home and with how companies from distant lands are competing in their homelands.

Douglas Wind and Pelmutter advocated four approaches of international business. They are:

Ethnocentric Approach: The excessive production more than the demand for the product, either due to competition or due to change in customer preferences push the company to exports the excessive production to the foreign countries. The company export the same product designed for domestic market to foreign market under this approach. Thus, maintenance of domestic approach towards international business is called ethnocentric approach.

Polycentric Approach: The company establishes a foreign subsidiary company and decentralized all the operations and delegates decision making and policy making authority to its executives. The executives of the subsidiary formulate the policies and strategies, design the product based on the host country's environment and the preferences of the local customer. Thus this approach mostly focuses on the conditions of the host country in policy formulation, strategy implementation and operations.

Regiocentric Approach: The foreign subsidiary considers the regional environmental for formulating policies and strategies. It market more or less the same product designed under polycentric approach in other countries of the region, but with different market strategies.

Notes

Geocentric Approach: Under this approach, the entire world is just like a single country for the company. They select the employees from the entire globe and operate with the number of subsidiaries. Each subsidiary functions like an independent and autonomous company in formulating policies, strategies, product design, human resource policies, operations etc.

1.7 Advantages of International Business

1. ***To achieve higher rate of profits:***
   - Expanding the production capacities beyond the demand of the domestic country
   - Severe competition in the home country
   - Limited home market
2. ***Political stability vs. political instability:***
   - Availability of technology and competent
   - Human resource
   - High cost of transportation
   - Nearness to raw materials
   - Availability of quality human resources at low cost
   - Liberalization and globalization
3. ***To increase market share:***
   - To achieve higher rate of economic development
   - Tariffs and import quotas
4. ***High living standards:***
   - Increased socio-economic welfare
   - Wider market
   - Reduced effects of business cycles
   - Reduced risks Large-scale economies
5. ***Potential untapped markets:***
   - Provides the opportunity for and challenge to domestic business
   - Division of labour and specialization
   - Economic growth of the world
   - Optimum and proper utilization of world resources
   - Cultural transformation
   - Knitting the world into a closely interactive traditional village.

Notes The foreign subsidiary considers the regional environmental for formulating policies and strategies.

Notes

Did u know? Generally all MNCs divide their markets according to geography. For example, Daewoo has divided its market as Europe, Africa, India, etc.

Caution Avoid ignorance towards a global perspective to the a good manager.

Case Study

Mayer & Company's Global Success

This is one game that India has permanently lost to its arch-rival Pakistan—manufacturing and exporting sports goods. Historically, when India and Pakistan were one before 1947, Sialkot, now in Pakistan, used to be the world's largest production centre for badminton, hockey, football, volleyball, basketball, and cricket equipment. After the creation of Pakistan, Jalandhar became the second centre after Hindus in the trade migrated to India. Soon, Jalandhar overtook Sialkot and till the early 1980s it remained so. However, when the face of the trade began to change in the 1980s and import of quality leather and manufacturing equipment became a necessity for quality production, Pakistan wrested the initiative as India clung to its policies of discouraging imports through high duties and restrictions. As it was, the availability of labour and skills was a common factor in both Sialkot and Jalandhar, but with Sialkot having the advantage of easier entry, most of the world's top sports manufacturers and procurers developed an association with local industry in Sialkot that continues even today.

Ten years later in the early 1990s, when Manmohan Singh liberalized the norms for importing equipment and raw material required for producing sports goods, it was too late as majority of the global majors had already shifted base to Sialkot. In 1961, the late Narinder Mayor started the first large-scale sports goods manufacturing unit, Mayor & Company, thereby laying the foundation of an organized industry. Even today, more than 70 per cent of the industry functions in an unorganized manner. Starting with soccer balls, Mayor expanded to produce inflatable balls like volleyballs, basketballs, and rugby balls.

Today, his two sons Rajan and Rajesh have built it up into five companies engaged in a wide array of businesses, though sports goods remain the group's core business. While the parent trading company, Mayor & Company, remains the leading revenue-earner to the tune of ₹ 55 crore annually out of a total group turnover of ₹ 85 crore-plus, Mayor's second venture, the Indo-Australian Mayor International Limited, is spinning another ₹ 15 crores. Mayor International is a 100 per cent Export-oriented Unit (EOU) exclusively manufacturing and exporting golf and tennis balls.

The product portfolio of the company comprises the following:

Inflatable Balls

- Soccer balls and footballs (Professional, Indoor, Match and Training, leisure toy)
- Volley balls, rugby balls (Volley balls and Beach Volley Balls)
- Australian rugby, hand balls (English League, Union and touch); (Australian rules, Australian Rugby League balls with laces).

Boxing Equipment

- Boxing and punching balls (Boxing and Punching balls, Head Gear, Gloves, Punching Mitts and Kits, Punching Bags & Bag Sets)

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Notes

- Gloves
- Goal keeper's gloves (Football/Soccer)
- Boxing gloves.

Cricket Equipment

- Worldwide distributor for Spading Cricket Bats, Balls and Protective equipment.

Hockey Equipment

- Worldwide distributor for Spading Hockey Sticks, Balls and Protective equipment.

Based in Delhi, Rajan Mayor, 41, is the CMD of the group, which also comprises an IT division working on **B2B** and **B2C** solutions; Voyageur World Travels in the tourism sector; a houseware exports division specializing in stainless steel kitchenware, ceramics, and textiles; and a high school. Younger brother Rajesh, 34, is the Executive Director and looks after all the divisions operating in Jalandhar, Technical director Katz Nowaskowaski divides his time equally between India and Australia, where he looks after the group's interests. "While inflatable balls are our prime competence in our core business, we are presently focusing on golf balls, for which we are the sole producers in South Asia. Out of a total ₹ 300 crore of sports goods business generated in domestic market, most of which is supplied by the unorganized players, golf balls constitute a miniscule amount and therefore we came up with a 100 per cent EOU for producing golf balls. Later, the same facility was utilized with little moderation for tennis balls too," says Nowaskowaski.

Clarifying that the sports good industry in India only includes playing equipment and not apparels or shoes, D K Mittal, chairman of the Sports Goods Export Promotion Council and joint secretary in the Ministry of Commerce, has certified Mayor Group as the number one exporter since 1993 till date, barring 1996. However, SGEPC secretary Tarun Dewan points out that being the number one exporter does not mean that Mayor is the number one brand being exported. "Actually we have tie-ups with Dunlop, Arnold Palmer, and Fila for manufacturing golf balls. For footballs and volleyballs we have associations with Adidas, Mitre, Puma, Umbro, and Dunlop. We manufacture soccer World Cup and European Cup replicas for Adidas, which is a huge market. Only 400 balls used for actual play in the World Cup are manufactured in Europe and that too only for sentimental reasons, otherwise we are capable of delivering products of the same, if not better quality. Now since we manufacture balls for them, we cannot antagonize them by producing balls of similar quality with our own brand name. Secondly, I agree that competing with such big giants in the world market in terms of branding is a task that is well beyond our reach at the moment. However, we are trying to brand ourselves in the domestic market and that is one of the prime focus areas in the coming year," says Rajan.

Coca-Cola, Unilever, McDonald's, American Airlines, Disney club, and other such big brands come up with huge orders at times for golf balls with their logos for promotional schemes. However, there is no mention of the producing country since these companies do not want to show that balls they deliver in the US are being produced in Asia, "Not only is our quality good enough; labour in India is cheap enough to churn out a much less expensive product in the end. Yet, the main threat to our industry comes from countries like Taiwan and China, who have already cornered a chunk of world markets in tennis, badminton, and squash rackets. This is primarily because of two reasons—slow responses to our needs in tune with the market requirements from the government and lack of infrastructure. And most importantly, tags 'Made in China' or 'Made in Taiwan' are more acceptable in the West than 'Made in India' or 'Made in Pakistan'. One of the mottos of the Mayor group has been to make 'Made in India' an acceptable label in the West. For that we stress quality, timely delivery, and competent rates. Yet, a lot depends on perception value, which in our case is sadly on the negative side, much owing to our government's stance

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Notes

over the years. Things might be improving, but the pace is very slow and as our economy drifts towards a free market scenario supinely, it might just prove to be too little too late in the end," says Rajesh.

Today, Mayor Group is sitting pretty as its competitors; Soccer International Sakay Trades, Savi, Wasan, Cosco, Nivia, and Spartan are only trying to catch up in the inflatable's category. With 1.2 million dozen golf balls, Mayor is way ahead of its competitors. The company is planning to enhance its manufacturing capacity to 1.5 million dozen golf balls next fiscal. With approval from the world's two top golf associations – the US PGA and RNA of Scotland, demand for its product is not a problem, the company's senior marketing officials point out. With the markets in Mayor's current export destinations – Europe, North America, Australia, and New Zealand – all set to expand in the coming years after the present slump, Mayor wants to expand its sports goods business that caters to 60 per cent of its overall exports. Though 40 per cent of exports come from house ware manufactured in Delhi and Mumbai, with export centres in the same countries for its sports goods, just about maintaining this business at its present state, and concentrating entirely on sports goods is what the Mayors are intent on. With nearly 2000 skilled workforce; quality certification from ISO 9001:2000 and ISO 14001: 2004; and having spread to more than 40 countries, Mayor and Company is obviously sitting pretty.

Questions

1. What routes of globalization has the Mayor group chosen to go global? What other routes could it have taken?
2. What impediments are coming in the Mayor group's way of becoming a major and active player in international business?
3. Why is 'Made in India' not liked in foreign markets? What can be done to change the perception?

Source: International Business Management by Raj

Self Assessment

Match the following:

11.	Path A	(a)	Deepening mode of commitment
12.	Path B	(b)	Leapfrogging of Expansion
13.	Path C	(c)	Geographic diversification
14.	Path D	(d)	Passive to active expansion
15.	Path E	(e)	External to internal handling of operations

1.8 Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- International business is all commercial transactions – private and governmental – between two or more countries. Private companies undertake such transactions for profits; Government may or may not do the same. These transactions include sales, investments and transportation.
- Study of international business has become important because (i) it comprises a large and growing portion of the world's total business, (ii) All companies are affected by global events and competition whether large or small since most sell output to and secures raw materials and supplies from foreign countries. Many companies also compete against products and services that come from outside India.

Notes

- The company's external environment conditions such as physical, societal and competitive affects the business functions such as marketing, manufacturing and supply chain management are carried out.
- When a company operates internationally, foreign conditions are added to domestic ones making the external environment more diverse and complex.
- This pervasive growth in market interpenetration makes it increasingly difficult for any country to avoid substantial external impacts on its economy.
- In particular massive capital flows can push exchange rates away from levels that accurately reflect competitive relationships among nations if national economic policies or performances diverse in short run.
- The rapid dissemination rate of new technologies speeds the pace at which countries must adjust to external events. Smaller, more open countries, long ago gave up illusion of domestic policy autonomy. But even the largest and most apparently self-contained economies, including the US, are now significantly affected by the global economy.
- Global integration in trade, investment, and factor flows, technology, and communication has been tying economies together.

1.9 Keywords

Ethnocentric Approach: Maintenance of domestic approach towards international business.

Foreign Direct Investment: A foreign direct investment is one that gives the investor a controlling interest in a foreign company.

Geocentric Approach: Under this approach, the entire world is just like a single country for the company.

International Business: Any firm that engages in international trade or investment.

Merchandise Export: Tangible products sent out of a country.

Polycentric Approach: This approach mostly focuses on the conditions of the host country in policy formulation, strategy implementation and operations.

Regiocentric Approach: It market more or less the same product designed under polycentric approach in other countries of the region, but with different market strategies.

1.10 Review Questions

1. Describe the concept of international business and explain its analysis.
2. What is the importance of international business?
3. Distinguish between the domestic trade and foreign trade.
4. Why companies engage in international business?
5. What are the reasons for phenomenon international growth in recent years?
6. Describe the evolution of international business.
7. Explain the drivers of globalization.
8. Describe the stages of internationalization.
9. Discuss the approaches of international business.
10. Highlight the advantages of international business.

Notes

Answers: Self Assessment

1.	1960	2.	Political
3.	Starts	4.	Business
5.	1980s	6.	Environmental
7.	National	8.	Size
9.	Houses	10.	International
11.	(d)	12.	(e)
13.	(a)	14.	(c)
15.	(b)		

1.11 Further Readings

Books

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Charles W.L. Hill, *International Business Competing in the Global Marketplace,* 4th Edition, Tata McGraw Hill, Publishing Company Limited.

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M. Kapagam, *Environmental Economics.*

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Online links

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Unit 2: Theories of International Trade

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Objectives

After studying this unit, you should be able to:

- Examine theories that explain why they are beneficial for a country to engage in international trade
- Describe the comparative advantage theory
- Explain the product life cycle theory
- Discuss the relative factor endowment theory

Introduction

The fundamental question that arises at this juncture is why should the business firms of one country go to another country, when the industries of that country also produce goods and market them? What is the basis for international business? A number of theories have been developed to explain the basis of international business.

2.1 Theories of International Trade – Mercantilism

Mercantilists maintained that the way a nation became rich and powerful was to export more than it imported. The resulting export surplus would then be settled by an inflow of bullion or precious metals, primarily gold and silver. Thus, the Government had to do all in its power to stimulate the nation's exports and discourage and restrict imports (particularly the import of luxury consumption of goods).

Notes

The principle assertion of Mercantilism was that 'a nation's wealth and prosperity reflects in its stock of precious metals such as, gold and silver', as at that time gold and silver, were the currency of trading nations. The basic tenet of Mercantilism is to maintain a trade balance where exports are greater than imports. Consistent with this belief, the Mercantilist doctrine advocated the government intervention. It means that their policy was to maximize exports and minimize imports. It means that imports were to be restricted, by means of tariff and quotas, whereas, exports were to be restricted by subsidies.

Criticism

1. The theory viewed trade as a zero sum game, a gain by one results in a loss by another. Adam Smith and David Ricardo showed the short-sightedness of the approach and demonstrated that trade is a positive sum game or a situation where all the countries benefit.
2. Mercantilists measured the wealth of a nation by the stock of precious metals it possessed. In contrast, today we measure the wealth of a nation by its stock of human man-made and natural resources, available for producing goods and services. The greater the stock of useful resources, the greater is the flow of goods and services to satisfy human wants and increase the standard of living of the nation.

2.2 Theory of Absolute Cost Advantage

According to Adam Smith, trade between two nations is based on absolute advantage. When one nation is more efficient than (or has an absolute advantage over) another in the production of one commodity but is less efficient than (or has an absolute disadvantage with respect to) the other nations in producing a second commodity than both the nation can gain by each specializing in the production of the commodity of its absolute advantage and exchanging part of its output with the other nation for the commodity of its absolute disadvantage. By this process resources are utilized in the more efficient way and the output of both commodities will rise. According to Smith, *"whether advantage which one country has over another by natural or acquired, is in this respect of no consequence"*.

Assumption

Adam Smith believed that all nations would gain from free trade and strongly advocated a policy of laissez faire (i.e. As little government interference with the economic system as possible) To illustrate, let there be two countries A and B having absolute differences in costs in producing a commodity each, X and Y respectively, at an absolute lower cost of production than the other. The absolute cost differences are given below:

Country	Commodity X	Commodity Y
A	10	5
B	5	10

From the above, Country A can produce 10X or 5Y with one unit of labour and country B can produce 5X or 10Y with one unit of labour.

In the above case, country A has an absolute advantage in the production of X (For 10X is greater than 5X) and country B has an absolute advantage in the production of Y (for 10Y is greater than 5Y). This can be expressed as

(10X of A)/ (5X of B) >1> (5Y of A)/ (10Y of B).

Trade between two countries will benefit both if A specializes in the production of X and B in the production of Y as is shown below:

Notes

Commodity → Country ↓	Production before trade (1)		Production after trade (2)		Gains from trade (2 – 1)	
	X	Y	X	Y	X	Y
A	10	5	20	--	+10	-5
B	5	10	--	20	- 5	+ 10
Total production	15	15	20	20	+ 5	+5

The above reveals that before trade both countries produce only 15 units each of the two commodities by applying one labour unit on each commodity. If A were to specialize in producing commodity X and use both units of labour on its total production will be 20 units of X. Similarly, if B were to specialize in the production of Y above, its total production will be 20 units of Y. The combined gain to both countries from trade will be 5 units each of X and Y.

Pitfalls

1. The theory is vague and lack clarity.
2. According to this theory, every country should be able to produce certain products at low cost compared to other countries and should produce certain other products at comparatively high costs than other countries. International trade takes place only under such conditions. But in reality, most of the developing countries do not have absolute advantage of producing at the lowest cost any commodity, yet they participate in the international business. Thus Smith's analysis is weak and unrealistic.

Case: Absolute Cost Difference

According to Adam Smith, the Father of Economics, the basis of international trade was absolute cost advantage. There may be a case where a commodity can be produced by two countries, but the cost of producing the commodity in one country is absolutely lower than the cost of producing it in the other country. In such a case, the commodity will be produced in that country where the cost of production is the lowest. This is explained as follows. Suppose:

In India, 10 days of labour can produce 100 units of cotton, or

In India, 10 days of labour can produce 50 units of jute.

In Pakistan, 10 days of labour can produce 50 units of cotton, or

In Pakistan, 10 days of labour can produce 100 units of jute.

In this case, in India the same number of labour days, can produce either 100 units of cotton or 50 units of jute. The cost-ratio between cotton and jute is, 100:50 or 1 unit of cotton = 1/2 unit of jute. Similarly, in Pakistan, the cost-ratio is, 50:100 or 1/2 unit of cotton = 1 unit of jute or 1 unit of cotton = 2 units of jute.

Absolute cost differences arise, when each of the two countries can produce the commodity, at an absolutely lower production cost, than the other. In above example, India has an absolute advantage over Pakistan, in the production of cotton and Pakistan has a similar absolute advantage over India, in the production of jute. India's superiority in the production of cotton is seen by the fact that:

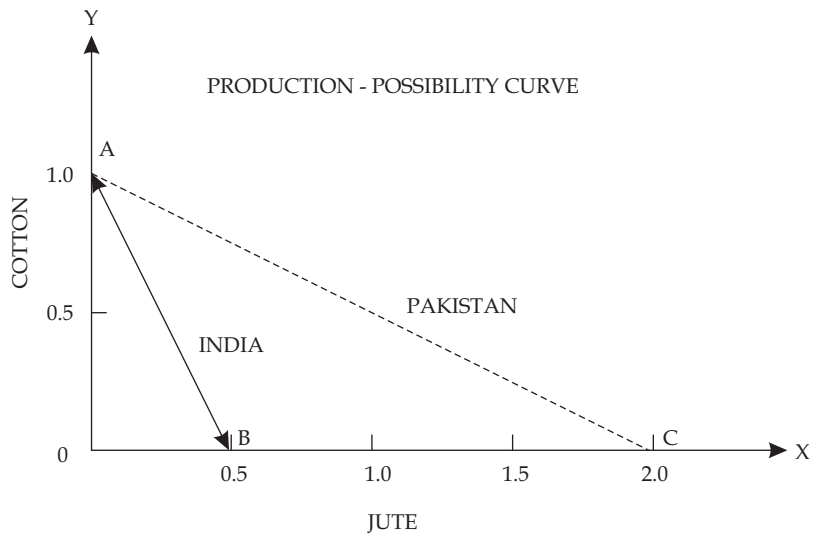
$$\frac{\text{100 units of cotton in India}}{\text{50 units of cotton in Pakistan}} > \frac{\text{50 units of jute in India}}{\text{100 units of jute in Pakistan}}$$

Notes

Now, if both India and Pakistan, form a part of only one country, each part will specialize in only one commodity, viz., India in the production of cotton and Pakistan in the production of jute. Division of labour between the two regions must lead to an increase in the total output. This is what exactly happens, when international trade takes place between these two countries. India will specialize in the production of cotton, export part of its output to Pakistan, as against import of jute. India will be prepared to enter into trade, so long, as it can secure more than 1/2 unit of jute for one unit of cotton (this is the cost ratio within India). Pakistan on the other hand, will be prepared to give, as much as 2 units of jute, for one unit of cotton. Hence, trade between the two countries will be very beneficial at any rate between 1/2 to 2 units of jute, for one unit of cotton. International trade will, therefore, definitely take place under conditions of an absolute difference in cost. But the trade between the two countries will not be for a long period or on a permanent basis.

Nowadays, there is a very small trade on this basis. This situation is explained in Figure 2.1.

Figure 2.1: Case of Absolute Cost Difference



In Figure 2.1, the production-possibility curves for India and Pakistan are prepared on the basis of 1 unit of cotton = 1/2 unit of jute and 1 unit of cotton = 2 units of jute, respectively. The line AB explains the position of India, where the distance along Y-axis i.e., OA (cotton) is double the distance along X axis, i.e., OB (jute). Similarly, line AC indicates the position of Pakistan, where the distance along Y-axis i.e., OA (cotton) is half the distance along X-axis i.e., OC (jute). BC is the amount of pure surplus, which can be distributed between the two countries, in case trade takes place. Any rate of exchange between B and C, will be beneficial to both the countries.

2.3 Comparative Cost Advantage Theory

According to the Comparative Cost Theory, countries in the long run will tend to specialize in the business (production and marketing) of those goods in whose business they enjoy comparative low cost advantage and import other goods in which the countries have comparative cost disadvantage, if free trade is allowed. This specialization helps in the mutual advantage of the countries participating in international business.

David Ricardo illustrated the Comparative Cost Theory in 1817. He used two countries, two-commodity model. The conclusions of his model are:

Notes

1. Trade between two countries is profitable when a country produces one good at a lower cost than another country and that other country produces another good at a lower cost than the former country.
2. Trade between two countries is also profitable when one country produces more than one product efficiently, but when it produces one of these products comparatively at greater efficiency than the other product.
3. Both the nations can engage in international trade when one country specializes in production in which it has greater efficiency than the other.

Assumption of the Theory

The following are the assumptions of the comparative cost advantage theory:

1. There are only two countries.
2. They produce the same two commodities.
3. There are similar tastes in both countries.
4. The only element of cost of production is labour.
5. The supply of labour is unchanged.
6. All units of labour is homogenous.
7. Prices of two commodities are determined by labour cost i.e. the no. of labour units employed to produce each.
8. Production is the subject to the law of constant returns.
9. Technological knowledge is unchanged.
10. Trade barriers between the two countries takes place on the basis of the barter system.
11. Factors of production are perfectly mobile within each country but are perfectly immobile between countries.
12. There is free trade between the two countries, there being no trade barriers or restrictions in the movement of commodities.
13. Trade is free from cost of transportation.
14. All factors of production are fully employed in both the countries.
15. The international market is perfect so that the exchange ration for the two commodities is the same.

Notes David Ricardo illustrated the Comparative Cost Theory in 1817.

Task Give and explain any example of the above mentioned theory.

Explanation of the Theory

Suppose the production of a unit of wine in England requires 120 men for a year, while a unit of cloth requires 100 men for the same period. On the other hand, the production of the same quantities of wine and cloth in Portugal requires 80 and 90 men respectively. Thus England

Notes

uses more labour than Portugal in producing both wine and cloth. Hence Portugal possesses an absolute advantage in both wine and cloth. Amongst the two Portugal's greater advantage is production of wine and exporting to England. Since the cost of production of wine 80/120 men is less than the cost of production of cloth 90/100 men. On the other hand, it is England's interest to specialize in the production of cloth in which it has least comparative disadvantage. Since the cost of production of cloth in England is less (100/90 men) as compared with wine (120/80 men). Thus trade is beneficial for both the countries.

Derivatives of the Theory

The advantages desired from this theory are:

1. Efficient allocation of global resources.
2. Maximization of global production at the least possible cost.
3. Product prices become more or less equal among world markets.
4. Demand for resources and products among world nations will be optimized.

Case: Comparative Cost Difference

There may be a second case, where two countries can produce two commodities. The factors of production may be so distributed that one country may produce both the commodities at a lower cost than the other country, but the greater advantage lies in the production of any one commodity instead of two. There is, therefore, a need for specialization. This is explained below.

Suppose:

In India, 10 days of labour can produce 100 units of cotton or

In India, 10 days of labour can produce 100 units of jute.

In Pakistan, 10 days of labour can produce 40 units of cotton or

In Pakistan, 10 days of labour can produce 80 units of jute.

In this example, the internal cost-ratio between cotton and jute in India is 100:100 or 1 unit of cotton = 1 unit of jute.

Similarly, the internal cost-ratio in Pakistan, between cotton and jute is 40:80 or 1 unit of cotton = 2 units of jute.

Comparative cost difference implies that, one of the two countries has an absolute advantage in the production of one commodity, than in the production of the other. In our example, India has an absolute advantage in the production of both the goods, since it can produce both, cotton and jute at a lower cost, as compared to Pakistan. But India's advantage is comparatively greater in the production of cotton, than in jute:

$$\frac{\text{100 units of cotton in India}}{\text{40 units of cotton in Pakistan}} > \frac{\text{100 units of jute in India}}{\text{80 units of jute in Pakistan}}$$

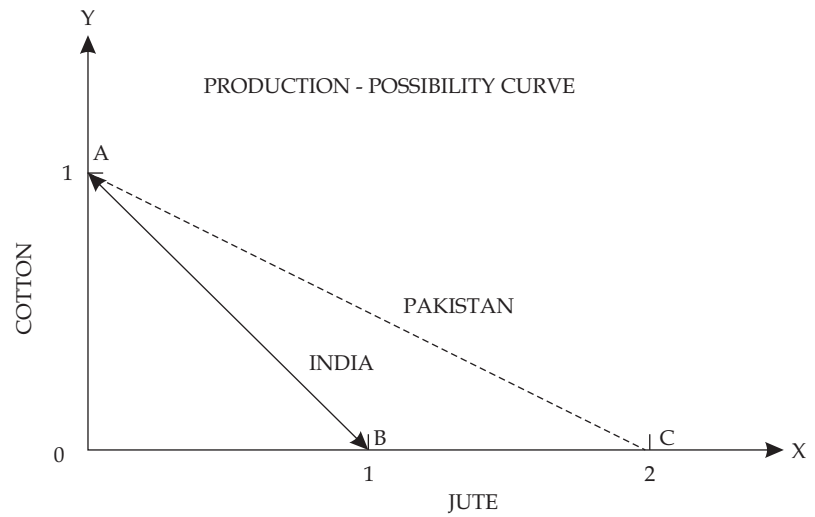
On the other hand, Pakistan has cost disadvantages in the production of both the goods, but its comparative cost disadvantage is less in the production of jute, than in cotton. To express the idea differently, Pakistan has a comparative cost advantage in the same production of jute, than in cotton:

$$\frac{\text{80 units of jute in Pakistan}}{\text{100 units of jute in India}} > \frac{\text{40 units of cotton in Pakistan}}{\text{100 units of cotton in India}}$$

Notes

International trade will be beneficial to both the countries, if each of them specializes in the production of that commodity, in which it has comparative cost advantage. India, therefore, will be prepared to specialize in cotton and export part of it, so long as it can get more than one unit of jute for 1 unit of cotton. Pakistan, on the other hand, will specialize in jute, provided it can secure 1 unit of cotton for 2 units of jute. Any rate between 1 to 2 units of jute for 1 unit of cotton, will benefit both the countries. Under such conditions, international trade is beneficial and hence, possible between the two countries. The principle of comparative advantage is explained in Figure 2.2.

Figure 2.2: Case of Comparative Cost Difference



In the figure, the line AB, represents the production-possibility curve for India and is based on the cost-ratio of 1 unit of cotton = 1 unit of jute. Line AC, explains the production-possibility curve for Pakistan and is based on the internal cost-ratio of l unit of cotton = 2 unit of jute. BC, is a pure economic surplus, which is to be shared by the two countries through trade. Any rate of exchange between B and C will be beneficial to the two countries.

Criticisms of the Theory

For a very long time, the classical theory of comparative cost, as formulated by Ricardo and refined by Mill et. al., held an undisputed say. It was considered to be the most appropriate explanation of the basis of international trade. Prof. Samuelson, expressing the elegance of this theory writes that, "If theories, like girls, could win beauty contests, the comparative advantage would certainly rate high in that, it is an elegantly logical structure." But in spite of its popularity, the theory has been put to a severe critical examination by some modern economists, like, Bertil Ohlin and Frank Graham. Ohlin describes the theory as clumsy and dangerous, i.e. unduly cumbersome and unreal. Moreover, it has been founded on an unrealistic assumption and has, therefore, been vigorously attacked as under:

1. ***Assumption of labour cost is no longer valid:*** The most forthright attack against the theory is, because of its assumption of labour costs. The assumption of labour theory of value on which it is based, has been long discarded. In actual practice all costs, nowadays, are measured in terms of money. Therefore, with the collapse of this major support, the theory falls flat.

   Here, it may be pointed out in support of the theory that it will be unjust to condemn it, merely on account of this assumption. Ricardo had expressed the theory in terms of

Notes

labour costs because of the prevailing belief in the labour theory of value. However, even if the assumption of labour cost is discarded and cost differences are translated in terms of money, the basic contents of the theory will still be valid.

2. ***Labor is not the only factor:*** Another objection against the comparative cost theory is that it regards labour as the only factor of production. In the modern enterprise, factors like 'capital' and 'entrepreneur' assume greater importance as compared to labour. On this account also, to restrict the cost of production only to labour cost is highly unrealistic and makes the theory ineffective.

3. ***Assumption of constant cost not valid:*** The classical theory is based on the unrealistic assumption of constant costs in real life. However, after a certain stage, every production is subject to increasing costs or diminishing returns. Thus, additional quantities, beyond this stage, can be produced only at a higher cost. As a result of this, with every increase in production, the cost-ratios in the two countries may be so altered that they may finally come to represent equal differences, rather than the comparative differences. The law of increasing costs, thus, implies another limitation of the theory of comparative cost.

4. ***Too much emphasis on supply side:*** Prof. Ohlin criticizes the theory on account of its complete neglect of the demand conditions. He regards the theory as "nothing more than abbreviated account of the conditions of supply." Because of their assumption of constant costs, classical economist explained the cost difference on the basis of supply conditions only. But, as we have seen above that costs do not remain constant; they do change with changes in output, which in turn is influenced by the level of demand.

5. ***Static theory:*** The theory is static in the sense that it assumes so many things as given and unalterable. Assumptions like 'full employment' and 'fixed and constant supply of factors of production' are far from reality. In the real world, everything is changing and changeable. The theory, therefore, does not fit into the dynamic nature of the present-day world.

6. ***Assumption of perfect mobility of factors within a country and their perfect immobility between the countries is not valid:*** Ohlin regards this assumption as dangerous and misleading. If the factors are mobile within a country, then why are there differences in wages in different occupations and differences in rates of interest in different regions? He regards the classical doctrine of comparative costs as a clumsy tool of analysis. Ohlin rejects the classical assumption of the immobility of factors of production between countries, as the basis of international trade. For him, immobility of factors is not a special feature of international trade, but is also prevalent within the different regions of the same country.

7. ***Assumption of perfect competition is unrealistic:*** Like other theories of classical economists, the comparative cost theory is also based on the assumption of perfect competition but it has been amply proved by modern economists that perfect competition exists nowhere. What we actually have is some sort of imperfect competition.

8. ***Absence of transport costs:*** The theory assumes transport costs to be absent. Actually, however, transport costs do make a difference in the direction and volume of international trade. There are several branches of production in which transport costs are even higher than production costs. A particular commodity cannot enter into international trade, unless the difference in production costs between the two countries is higher than the costs of transporting it from one country to another. Transport costs are, thus, too important to be ignored. For example, sometime back Germany was one of the leading exporters of coal and yet some of the near-by German ports found it more economical to import coal from Britain. Here, comparative advantage was outweighed by transport costs.

9. ***Based on two countries – two commodities model:*** The theory has also been criticized on the ground that it takes into consideration only two countries having only two commodities to exchange. In actual practice, trade is multilateral, involving many countries. This, however,

is not a very damaging criticism. Even if this assumption is removed, it will not make a material change in the basic contents of the theory.

10. ***Comparative advantage and specialization:*** Professor Graham points out that the theory loses its ground, when we find that comparative advantages will never lead to complete specialization on the part of two countries, which enter into international trade. This may happen when one country is big and another small. The small country will be in a position to specialize fully as, "it can dispose off its surplus, to the other country. But the bigger country cannot have such complete specialization because:

    (a) It will not be able to meet all its requirements fully from the foreign country; and

    (b) If it will fully specialize in a particular production, its surplus output will be of such a large magnitude that it will not be entirely absorbed by the importing small country.

Self Assessment

Choose the appropriate answers:

1. If the cost of production of items A and B in France and Germany are as given below, which statement will hold well?

	Germany	France
A	15	20
B	12	24

    (a) France will import A and B from Germany

    (b) France will import A from Germany

    (c) France will import B from Germany

    (d) Germany will import A from France

    (e) France will export A to Germany and import B from Germany

2. If we know that American agriculture is the most efficient in the world, we may say that:

    (a) If America is also more efficient in the production of all other goods, there could be no gain from trade

    (b) It would never pay Americans to import food

    (c) It would always pay Americans to import food

    (d) America might or might not be a food importer

    (e) America clearly never exports food

3. The assumption made by the theory of comparative advantages is:

    (a) Full employment

    (b) Mobility of labour within the country

    (c) Constant returns to scale

    (d) All of the above

    (e) Both (a) and (b) above

Notes

Fill in the blanks:

4. ..... maintained that the way a nation became rich and powerful was to export more than it imported.
5. According to ....., trade between two nations is based on absolute advantage.

2.4 Relative Factor Endowment Theory

Two Swedish economists Eli Heckscher and Bertil Ohlin developed the factor proportion theory of international trade, also known as the modern theory of international trade. Modern Theory of International Trade was propounded by Heckscher in an article published in 1919. It was further improved upon by his student Bertil Ohlin in a research paper published in 1924 and later in his book *"International and Inter-regional Trade"* published in 1933. This theory does not contradict Comparative Cost Theory of International Trade, rather supports it. According to Comparative Cost Theory, international trade takes place because of difference in comparative costs. But it throws little light on the factors accounting for the difference in comparative costs. On the contrary, modern theory of international trade reveals the causes responsible for difference in the international trade.

Statement of the Theory

According to this theory, there is difference in factor endowments among different countries of the world. For instance, certain countries have comparatively large supply of labour while in others the supply of capital is relatively large. Because of difference in factor endowments there is difference in the prices of the factors. Difference in the prices of the factors depends on their relative scarcity or abundance. Owing to difference in the prices of the factors, there is difference in the costs of the goods. Hence, this theory states that the main cause of difference in comparative costs is the difference in factor endowment. Thus, international, trade takes place because of diversity in factor endowments and hence difference in prices. Each country will export that commodity in the production of which such factor is used whose supply is relatively abundant and price is relatively cheaper. On the other hand, it will import that commodity in the production of which that factor is used whose supply is relatively scarce and price is relatively dearer. According to this theory, conditions of supply alone determine the pattern of international trade. BO Sodersten, writes that

"Some countries have much capital, others have much labour. The theory now says that countries that are rich in capital will export capital intensive goods and countries that have much labour will export labour intensive goods".

Definitions

In the words of Salvatore, *"The Heckscher-Ohlin Theory states that difference in relative factor endowments and factor prices between nations is the most important cause of trade. This theory predicts that each nation will export the commodity in the production of which a great deal of relatively abundant and cheap factor is used and import the commodity in the production of which a great deal of its relatively scarce and expensive factor is used. The theory also predicts that trade will lead to the reduction in the difference in factor prices between nations. "*

According to Ohlin, *"Immediate cause of inter-regional trade is always that goods can be bought cheaper in terms of money than they can be produced at home and here is the case of international trade."*

Notes

Assumptions of the Theory

Some of the assumptions of the theory are discussed below:

1. This theory relates to two countries, two commodities and two factors. It is therefore called 2 × 2 × 2 model.
2. There is same production function for each commodity in two countries.
3. Factors are mobile within the country but immobile between two countries.
4. There is perfect competition in all markets. As a result (i) all factors are fully employed, (ii) factors get their reward in accordance with their marginal productivity, (iii) prices of the commodities are equal to their marginal productivity.
5. No restriction is imposed on the exchange of goods, i.e., free trade exists between two countries.
6. Consumers' tastes and preferences are identical in two countries.
7. Technique of production employed in two countries is the same.
8. There is lack of transport costs.
9. Factor endowments are different in two countries.
10. Goods can be classified on the basis of factor intensity, such as, capital intensive goods and labour intensive goods, etc.
11. Production function of all goods is homogeneous of the first degree. It means that output will be doubled if all factors of production are doubled.

Did u know? Swedish economists Eli Heckscher and Bertil Ohlin developed "Factor proportion theory of International Trade" in year 1919.

2.4.1 Explanation of the Theory

According to Ohlin "*International Trade is but a special case of inter-regional trade.*" Different regions have different factor endowments, i.e., some regions have abundance of labour but scarcity of capital while other regions have abundance of capital but scarcity of labour. Different goods have different production functions, i.e., factors are combined in different proportions to produce different commodities. Some goods are produced by employing relatively large proportion of labour and relatively small proportion of capital. Still other goods are produced by employing relatively small proportion of labour and relatively large proportion of capital. In this way, each region is suitable for the production of those goods for whose production it has relatively abundant supply of the required factors. A region is not suitable for the production of those goods for whose, production it has relatively scarce or zero supply of the essential factors. Hence, different regions have different capacity to produce different commodities. Difference in factor endowments is, therefore, the main cause of international trade along with inter-regional trade.

According to Ohlin, "*Immediate cause of inter-regional trade is always that goods can be bought cheaper in terms of money than they can be produced at home and here is the case of international trade*." Heckscher in his article, "*The effect of Foreign Trade on the Distribution of Income*" published in 1919 had supported the classical theory of comparative costs and maintained that international trade took place because of differences in comparative costs. But classical theory did not explain why there was difference in comparative costs. Answering to this question, Heckscher cites the following causes for difference in comparative costs:

1. Difference in factor endowments
2. Difference in factor intensities

Notes

According to Heckscher-Ohlin Theory of International Trade, the immediate cause of international trade is the difference in relative commodity prices. The cause of difference in the relative prices of the goods is the difference in the amount of factor endowments, like capital and labour, between the two countries. As a result, there is difference in the relative demand and supply of factors. These differences cause difference in the prices of the factors. It is due to difference in factor prices that difference in the relative prices of the commodities takes place and it is this difference that constitutes the main cause of international trade.

Goods, which require scarce factors on a large-scale are imported because their domestic prices are high. On the contrary, goods, which require abundant factors on a large scale, are exported as their domestic prices are low. For instance, if capital is abundant in USA, it will be relatively cheap. Hence, USA will export those goods which are capital intensive. On the contrary, if labour is abundant in India, it will be relatively cheap. Hence, India will export those goods which are labour intensive.

Notes International trade takes place because of diversity in factor endowments and hence difference in prices.

2.4.2 Concept of Relative Factor Endowment

Abundance or scarcity of factors of Heckscher-Ohlin theory has been explained on the basis of two criterions:

Price Criterion of Relative Factor Endowment

Price criterion of factor endowment means that a country where capital is relatively cheap and labour relatively dear will be called capital abundant country, even if the quantity of capital in that country is relatively less. On the contrary, if capital is relatively dear and labour relatively cheap, such a country will be called capital scarce country, even if the quantity of capital in such a country is relatively more. In other words, the criterion of factor abundance or factor scarcity is not the quantum of the factor but its price. On the basis of price criterion, international trade theory can be explained with the help of an example.

Example:

Diagrammatic Explanation

Let us take USA and India as two trading countries. It is assumed that USA is a capital intensive country and India is a labour intensive country, i.e., capital is cheaper in USA in relation to labour; and labour is cheaper in India in relation to capital. This can be expressed in terms of the following equation:

USA		India
P_K	<	P_K

Here, P_K: price of capital; P_L : price of labour; < : less than

Both the countries are producing watches and shirts. While the production of watches is capital intensive, the production of shirts is labour intensive. According to Heckscher-Ohlin theory, India should specialise in the production of shirts and USA should specialise in the production of watches. This is illustrated in Figure 2.3.

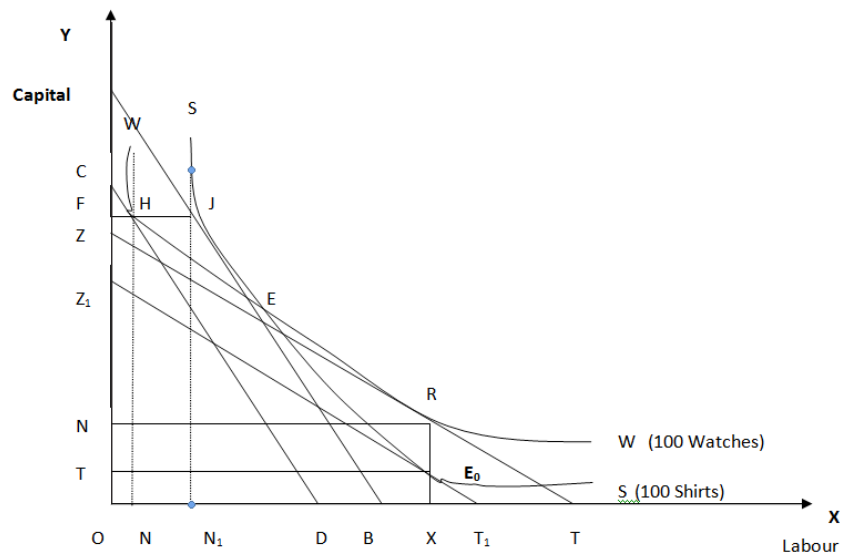
Notes

In this figure, labour is shown on the X-axis, and capital is shown on the Y-axis. WW is isoquant* showing production of 100 watches, and SS, is the isoquant showing production of 100 shirts.

AB and CD are Isocost** lines for USA. These are parallel straight lines, which means their slope is same and, (since slope shows price ratio) these isocost lines are showing the same price ratio.

These isocost lines are inclined towards OY-axis, showing that in USA, capital is cheaper in relation to labour. Likewise ZT and Z_1T_1 are isocost lines for India. These are inclined toward OX-axis, showing that, in India, labour is cheaper in relation to capital. These lines are also parallel and showing the same price ratio.

Figure 2.3: Price Criterion of Relative Factor Endowment



Thus,

$$\frac{OZ}{OT} = \frac{OZ_1}{OT_1}$$

Isoquants WW and SS are intersecting each other only at point E. This implies that there is no reversal of factor intensity. Or that in both USA and India, production of watches is capital intensive, and production of shirts is labour intensive. This conclusion is based on the assumption of Heckscher-Ohlin theory that both in USA and India, production function of watches or of shirts is similar.

The diagram shows that, in case of USA, isocost line CD and isoproduct curve WW for watches are tangent at point H. So that, for USA Production Cost for 100 Watches = OF Capital + ON Labour

As regards the production of shirts, we find isocost line AB and isoproduct curve SS are tangent at point J. So that for USA,

Production Cost of 100 shirts = OF Capital + ON_1 Labour.

* An Isoproduct curve is a curve that shows different possible combinations of two factors of production, like capital and labour, yielding the same amount of output.

** An Isocost line is that line which shows the various combinations of factors which can be obtained at the same cost. It is also called budget line. It shows what possible combinations of factors a firm can obtain at the same cost. Isocost line also shows cost-ratio of the factors.

Notes

In USA, capital cost of production of watches or of shirts is equal to OF, but labour cost of shirts is ON_1. While labour cost of watches is ON.

Implying that labour cost of shirts is more by NN_1 (ON_1– ON = NN_1) units of labour.

Thus, USA can produce watches at relative lesser cost, compared to the production of shirts.

In case of India, isocost line ZT and isoproduct curve WW for watches are tangent at point R. So that, for India,

Product Cost of 100 Watches = ON Capital + OX Labour

Likewise isocost line Z_1T_1 and isoproduct curve SS for shirts are tangent at point EI. So, that, Product Cost of 100

Shirts = OT Capital + OX Labour

Thus, in India, labour cost of watches and shirts = OX but capital cost of shirts is less than the capital cost of watches by NT capital (ON – OT = NT). This suggests that India can produce shirts at lesser cost compared to watches. Therefore, India should specialize in the production of shirts and export the same.

It is thus, suggested that because capital is relatively cheaper in USA and because labour is relatively cheaper in India, USA should specialize in the production of capital-intensive goods i.e., watches and India should specialize in the production of labour-intensive goods i.e., shirts. USA will export watches to India, while India will export shirts to USA.

Physical Criterion of Relative Factor Endowment

Physical criterion of factor abundance or scarcity means that if in a country capital ratio is greater than labour as against another country, then it will be called capital intensive country. Likewise, if in a country labour ratio is greater than capital as against another country, then it will be called labour intensive country. In other words, basis of this criterion is the physical quantity of the factors. On the basis of this criterion, international trade can be explained with the help of the following example.

Example:

Example: According to Heckscher-Ohlin whether two countries, say USA and India, are capital intensive or labour intensive depends on the fulfilment of the following condition:

$$\frac{K_u}{L_u} > \frac{K_i}{L_i}$$

(Here K_u = Quantity of Capital in USA; L_u = Quantity of Labour in USA; K_i = Quantity of Capital in India; L_i = Quantity of Labour in India)

USA will produce capital intensive and India, labour intensive goods. It is illustrated in the following figure. GG_1 is the production possibility curve of USA and II_1 is the production possibility curve of India.

Labour intensive production, i.e., shirts, is shown on OX-axis and capital intensive production, i.e. watches, is shown on OY-axis. If both the countries produce both the goods in the same ratio, then they will produce along OR-ray. USA will produce at point E of its production possibility curve GG_1 and India will produce at point F of its production possibility curve II_1. It is evident from this figure that at point E, the slope of production possibility curve of USA is steeper and at point F while the slope of production possibility curve of India is flatter. It is clear from the fact that P_1P_1 price line of USA is steeper than P_2P_2 price line of India. It proves that watches are cheaper in USA and shirts are cheaper in India. USA should produce more of capital intensive

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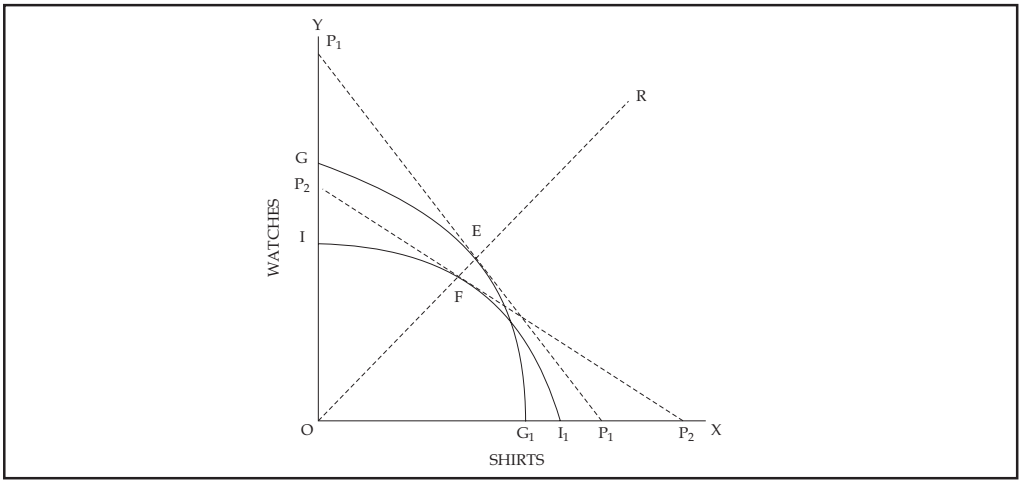
goods viz., watches. It may however, be noted that the above analysis does not clarify whether USA will export watches and India shirts. Answer to this question depends on the demand for these goods. If the domestic demand of USA for watches is less than the supply, then alone it will export watches, otherwise not. Likewise, India too will export shirts only if domestic demand for shirts is less than the supply.



Did u know? It was Eli Heckscher who proved that international trade take place because of difference of costs in different countries.

Self Assessment

Fill in the blanks:

6. Price criterion of factor ..... means that a country where capital is relatively cheap and labor relatively dear will be called capital abundant country.
7. ..... criterion of factor abundance or scarcity means that if in a country capital ratio is greater than labour as against another country, then it will be called capital intensive country.
8. ....., which require scarce factors on a large-scale, are imported because their domestic prices are high.
9. If in a country labour ratio is greater than ..... as against another country, then it will be called labour intensive country.
10. If capital is relatively dear and labour relatively cheap, such a country will be called capital ..... country.

2.5 Country Similarity Theory

This theory was developed by Staffan B. Linder, a Swedish economist, on the basis of his observation of the pattern of international trade since 1970s. According to this theory, developed countries trade more with other developed countries. About ¾ of total world exports is among the developed countries.

This fact, by itself, is an indictment of Heckscher-Ohlin's factor endowment theory. According to the H-O theorem, the incentive to trade is greatest among nations of radically different factor endowments. This means that trade would take place in larger part between developed manufacturing countries and developing countries producing primary products (i.e., natural resource commodities such as oil and petroleum) and labour-intensive products.

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Basic Tenets of the Theory

This theory has three main tenets:

1. ***Difference in factor endowments:*** It explains trade in natural resource-intensive products and that a country's manufactured exports are determined by internal demands.
2. ***Preference similarity boosts trade between the two industrialized countries:*** Linder also contends that the more similar the demand preference for manufactured goods in two countries (e.g., the United States and United Kingdom), the more intensive is the potential trade in manufacturers between them. If two countries have the same or similar demand structures, then their consumers and investors will demand the same goods with similar degrees of quality and sophistication, a phenomenon known as preference similarity. This similarity boosts trade between the two industrialized countries.
3. ***Average per capita income is the most important determinant of the demand structure:*** To explain the determinants of the demand structure. Linder argues that average per capita income is the most important one. Countries with high per capita income will demand high quality luxury consumer goods and sophisticated capital goods; while low per capita income countries will demand low quality necessity consumer goods and less sophisticated capital goods. Consequently, a rich country that has a comparative advantage in the production of high-quality, advanced goods will find its big export markets in other affluent countries where people demand such products.

Staffan B. Linder divided international trade into two different categories: primary products and manufactured goods. Linder asserts that differences in factor endowments explain trade in natural resource-intensive products but not in manufactured goods. He argues that the range of a country's manufactured exports is determined by internal demands. International trade in manufactured goods takes place largely among developed nations because nations will only export those goods they manufacture at home and will manufacture at home only those goods for which there is a strong domestic demand.

Caselet **International Finance Facility: The Global Marshall Plan?**

More than one billion people (i.e., one sixth of the world's population) live in extreme poverty with lack of water, proper nutrition, basic healthcare and the welfare services needed to survive. This is in spite of the fact that various loans and grants have been extended to alleviate poverty. On September 8, 2000, 152 Heads of State attending the UN's Millennium Summit unanimously adopted Millennium Development Goals (MDGs) taking a collective responsibility to uphold the principles of human dignity, equality and equity at a global level. But the implementation of the goals was hampered due to the shortage of funds. To finance the MDGs, Gordon Brown, the UK's Chancellor of the Exchequer, proposed the setting up of an International Finance Facility, which would aim to increase worldwide aid funding from $50 billion to $100 billion, by issuing bonds that were backed by aid pledges made by donor countries, in the international capital markets.

Source: http://www.ibscdc.org/Case_Studies/International%20Trade%20and%20Finance/ITF0027.htm

2.6 Product Life Cycle Theory

Raymond Vernon initially proposed the product life cycle theory in the mid-1960s.Vernon argued that the wealth and size of the US market gave us firms a strong incentive to develop cost-saving

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process innovations. Vernon further 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 centre of decision-making, given the uncertainty and risks inherent in introducing new products. Also the demand for most new products to be raised on non-price factors. Consequently, firms can charge relatively high prices for new products, which obviate 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.

Overtime demand for the new product starts to grow in other advanced countries (e.g. Great Britain, France, Germany and Japan). It becomes profitable for foreign producers to begin producing for their home markets. In addition, US firms might set up production facilities in those advanced countries where demand is growing.

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 mare, as developing countries (e.g. Thailand) begin to acquire a production advantage over advanced countries. Thus the focus 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 is that over the time the United States switches from being exporter of the producer to an importer of the product as production becomes concentrated in lower-cost foreign locations and then developing countries.

2.6.1 Stages of Product Life Cycle

There are three stages of the product cycle.

Stage 1: The New Product

Innovation requires highly skilled labour and large quantities of capital for research and development. The product will normally be most effectively designed and initially manufactured near the parent firm and therefore in a highly industrialized market due to the need for proximity, information and communication other than the many different skilled-labour components required.

In the development stage, the product is non-standardized. The production process requires a high degree of flexibility (meaning continued use of highly skilled labour). Costs of production are therefore quite high. The innovator at this stage is a monopolist and therefore enjoys all of the benefits of monopoly power, including the high profit margins required to repay the high development costs and expensive production process. Price elasticity of demand at this stage is low; high-income consumers buy it regardless of cost.

Stage 2: The Maturing Product

As production expands, its process becomes increasingly standardized. The need for flexibility in design and manufacturing decline, and therefore, the demand for highly skilled labour also decline. The innovating country increases its sales to other countries. Competitors with slight variations develop, putting downward pressure on prices and profit margins. Production costs are an increasing concern.

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As competitors increase their pressures on price, the innovating firm faces critical decisions on how to maintain market share. Vernon argues that the firm faces a critical decision at this stage, either to lose market share to foreign-based manufacturers using cheaper labour or to maintain its market share by exploiting the comparative advantages of factor costs by investing in other countries. This is one of the first theoretical explanations of how trade and investment become increasingly intertwined.

Stage 3: The Standardized Product

In this final stage, the product is completely standardized in its manufacture. Thus, with access to capital in world capital markets, the country of production is simply the one with the cheapest unskilled labour. Profit margins are thin and competition is fierce. The product has largely run its course in terms of profitability for the innovating firm.

The country of comparative advantage therefore, shifts as the technology of the product's manufacture matures. The same product shifts in its production location. The country producing the product during that stage enjoys the benefits of net trade surpluses. But such advantages are fleeting, according to Vernon. As knowledge and technology continually change, so does the comparative advantage of the producer country.

2.6.2 Trade Implications of the Product Cycle Theory

Product cycle theory shows how specific products were first produced and exported from one country but, through product and competitive evolution, shifted their location of production and export to other countries overtime. Figure 2.4 illustrates the trade patterns that Vernon visualized as resulting from the maturing stages of a specific product cycle. As the product and the market for the product mature and change, the countries of its production and export shift.

The product is initially designed and manufactured in the United States. In its early stages (from time t_0 to t_1), the United States is the only country producing and consuming the product. Production is highly capital-intensive and skilled-labour intensive at this time. At time t_1, the United States starts exporting the product to other advanced countries. These countries possess the resources to purchase the product in its still. New Product Stage, in which it is relatively high priced. These other advanced countries also commence their own production at time t_1 but continue to be net importers. A few exports, however, do find their way to the less developed countries at this time as well.

As the product moves into the second stage, the Maturing Product Stage, production capability expands rapidly in the other advanced countries. Competitive variations (products) begin to appear as the basic technology of the product becomes more widely known, and the need for skilled labour in its production declines. These countries eventually also become net exporters of the product near the end of the stage (time t_3). At time t_2, the Less Developed Countries begin their own production, although they continue to be net importers. Meanwhile, the lower cost of production from these growing competitors turns the United States into a net importer by time t_4. The competitive advantage for production and export is clearly shifting across countries at this time.

The third and final stage, the Standardized Product Stage, sees the comparative advantage of production and exports shifting to the less developed countries. The product is now a relatively mass-produced product that can be made with increasingly less-skilled labour. The United States continues to reduce domestic production and increase imports. The other advanced countries continue to produce and export, although exports remain at peak as the less developed countries expand production and become net exporters themselves. The product has run its course or life cycle in reaching time t_5.

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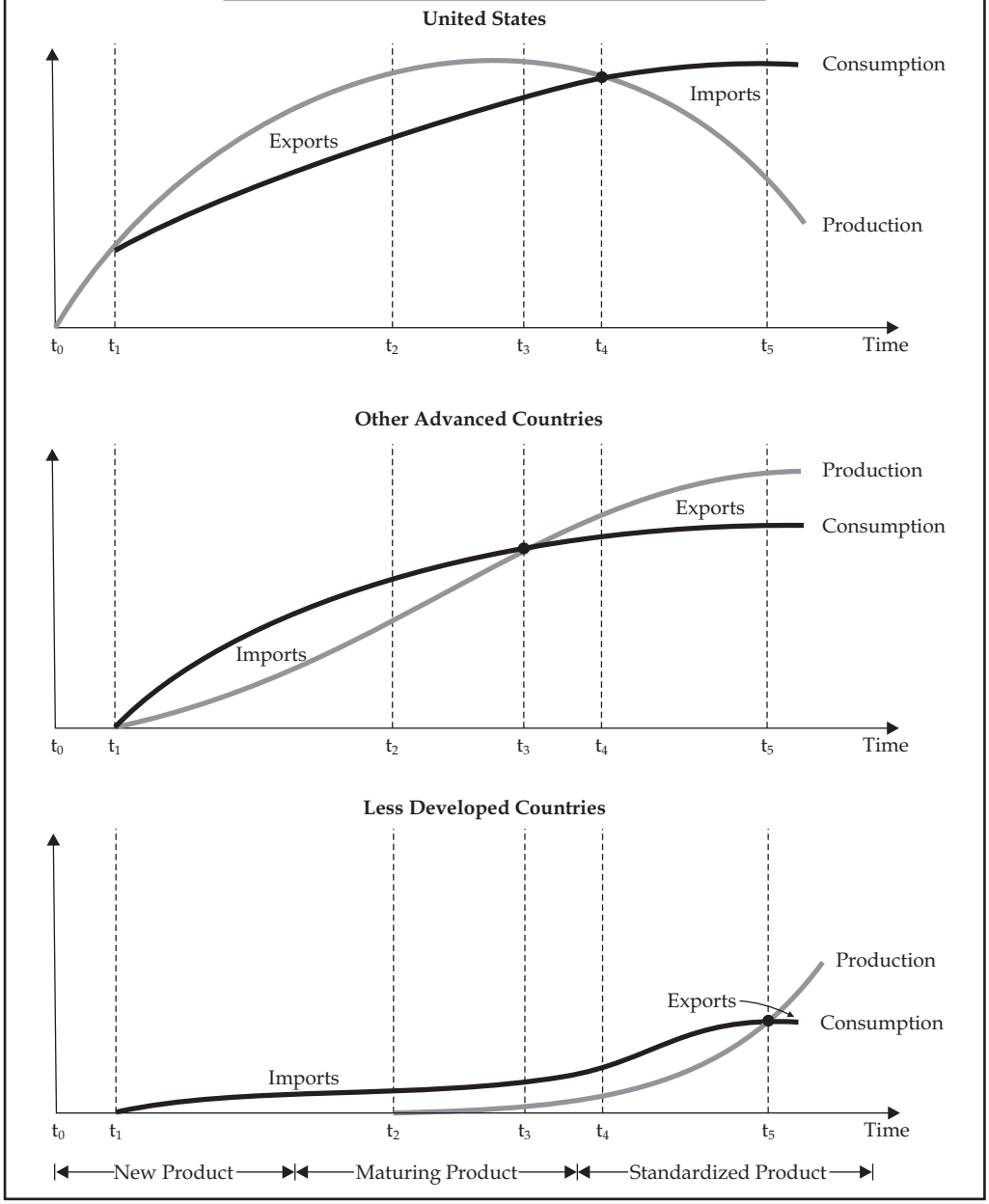
Figure 2.4: Trade Patterns and Product Cycle Theory



Historically, the product life cycle theory provides an accurate explanation of international trade patterns. Consider photocopiers; the product was developed in the early 1960s by Xerox in the United States and sold initially to US users. 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 in to 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 US users began to buy some of their photocopiers from lower-cost foreign sources, particularly from Japan. More recently, Japanese companies have found that their own country is too expensive to manufacture photocopiers, so they have begun to switch production to developing countries such as Singapore and Thailand. As a result, initially the United States and now several other advanced countries have switched

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from being exporters of photocopiers to being importers. This evolution in the pattern of international trade in photocopiers is consistent with the predictions of the product life cycle theory. The theory clearly explains the migration of mature industries out of the United States to low-cost assembly locations.

Caution Technological changes can affect the degree of comparative advantage for a country and its production of a certain product.

2.6.3 Limitations of Product Life Cycle Theory

This theory has been criticized because of the following weaknesses:

1. ***Applicable on technology-based products:*** The technology-based products normally experience the changes in production process as they grow and mature. Other products such as resource-based (minerals) or services which employ capital in the form of human capital are not easily characterized by the stages of maturity.
2. ***Most new products are not developed and introduced in the United States:*** Although it may be true that from 1945 to 1975, most new products were introduced in US, there have always been important exceptions. In recent years, it has been noted that many new products are now introduced in Japan, US and the advanced European nations (laptops, computers, compact disks and electronic cameras).

It is thus evident from above that Vernon theory may be useful for explaining the pattern of international trade during the brief period of American global dominance; its relevance, however, in the modern world is limited.

Notes Most new products are not developed and introduced in the United States.

Did u know? Product life cycle theory clearly shows that mature industries always relocate to low-cost assembly locations.

Self Assessment

State whether the following statements are true or false:

11. As ..... expands, its process becomes increasingly standardized.
12. ..... initially proposed the product life cycle theory in the mid-1960s.
13. To explain the determinants of the demand structure, ... argues that average per capita income is the most important one.
14. The ..... products normally experience the changes in production process as they grow and mature.
15. Staffan B. Linder divided international trade into two different categories: ..... products and ..... goods.

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Case Study

The Indian Cashew Processing Industry

Even though the cashew tree grows fruit, it is best known for its nuts. India is the world's largest producer, processor and exporter of cashew. In 2000, India accounted for 65 percent of the $208 million in total global exports. The fruit of the tree (known as the cashew apple), however, drew the earliest attention. The Tupi Indians of Brazil, first harvested the cashew apple in the wild. They later introduced it to the early Portuguese traders, who, in turn, propagated the tree in other tropical countries. But attempts to grow the tree on the plantations proved unsuccessful, because it was vulnerable to insects in the close quarters of plantations. Instead, some of the abandoned plantation trees propagated new trees in the wild forests of India, East Africa, Indonesia and South-East Asia.

Two other factors inhibited the early harvest of the cashew nut. Firstly, cashew fruit matures before the nut and the fruit will be kept only about 24 hours, after harvesting the nut. So, the fruit is usually discarded in the pursuit of the nut, which, if dried, can last a year or longer. Secondly, the processing of cashew nuts is tedious and time-consuming. In the 1920s, however, India developed a cashew-processing industry in response to the growing demand for cashew nuts among Indian consumers.

The processing required much manual dexterity and low wage rates, because the nut is contained beneath layers of shell and thin skin. To remove the shell, the workers must place the nut in an open fire for a few minutes and then tap it (while still hot), with a wooden hammer. If the nut breaks from the tapping, its value decreases considerably. Once the workers remove the shell, they place the nut in an oven for up to 10 hours, after which they remove the skin by hand, while the nut is still warm, without the use of fingernails or any sharp objects that can mark or break the surface. The workers then sort the nuts into 33 grades, based mainly on size and wholeness. The highest grades sell for several times the price of the lowest grades, which are sold almost entirely to the confectionery industry. India maintained a virtual monopoly on cashew processing, until the mid-1970s. This monopoly was due to three factors:

1. India was the largest producer of cashews.
2. Early demand occurred largely in India, meaning that any other country would have to incur added transport charges to reach the Indian market.
3. Most importantly, the Indian workers were particularly adept at the process technology.

Through the years, other factors threatened India's prominence as a cashew producer. Firstly, a shortage developed, when the demand for the nuts grew in the United States and the United Kingdom. Secondly, because the nuts were ill-suited for plantation growth, India could not produce enough and thus turned to East Africa, especially Mozambique, Tanzania and Kenya, for supplies. Those countries were experiencing high unemployment and were at first eager to sell the raw nuts, which grew in the wild. But by the 1950s, they began to realize that they could bypass India, by processing the raw nuts themselves. Cashew-processing methods were well known and did not require the East Africans to invest in expensive machinery. So there was no technological obstacle. Mozambique became the world's largest cashew grower by the mid-1970s and processed cashews became the country's leading export. However, because the Indian labour force worked on making handicrafts at home as children, by the time they were employed in cashew processing, they could perform delicate hand operations efficiently. Without such training, the East Africans were at a fatal disadvantage. Further, the Mozambique government neglected

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reinvestments in the state-owned processing plants and many of the trees became diseased and too old to be productive. By the 21st century, Mozambique was no longer a major player in the industry.

Although the Africans' inability to compete, granted a reprieve to the Indian industry, it put it on notice, that it was vulnerable to supply cut-offs. The Indian Council for Agricultural Research, the International Society for Horticultural Sciences, and the Indian Society for Plantation Crops, expanded their efforts to increase India's production of raw nuts. Concomitantly, three different companies developed mechanical equipment to replace hand processing. They sold equipment to East African countries and Brazil in the 1970s. These countries reduced their exports of raw nuts to India to maintain supplies for their own processing.

Three factors have kept India's hand-processing industry afloat:

1. The machinery breaks many cashew nuts, so Indian processors have had an advantage in the sale of higher-grade nuts. At any time, however, newer machinery might solve the breakage problem, again threatening the approximately 200 Indian processors and their 300,000 employees. Moreover, there is an increased competition for the lower-grade output.
2. Indian processors have been able to obtain increased supplies of raw nuts, partially as a result of the increased Indian production. Pesticide technology now makes cashew tree plantations feasible, increasing the number of trees per acre. Nevertheless, about 97 per cent of nuts come from trees in the wild. Indian experimentation in hybridization, vegetative propagation and grafting and budding techniques, promises to increase the output per tree to five times what it was in the wild. Further, India has been increasing its imports of raw nuts substantially, primarily from Tanzania.
3. India uses fewer fertilizers than Brazil, the biggest export competitor and the lack of fertilizer apparently gives, Indian nuts, a better flavour.

Because its exports consist of a higher portion of higher-grade nuts and because of the flavour differences, Indian exports sell for a premium in comparison with those of competitors, for example, about 15 percent more than nuts from Brazil. However, yields are usually higher in Brazil, and Brazilian processors pay only between 30 and 36 percent of the price, the Indian processors pay for raw nuts. Further, because of differences in domestic demand, India typically exports about 50 percent of the raw kernels that it processes, whereas, Brazil exports about 85 percent. In the mid-1990s, Brazil suffered crop problems, which enabled India to gain an increase in the global export share of processed cashew kernels.

During the 1990s, India depended heavily on imported raw nuts from Vietnam. However, Vietnam has since, become a competitor by processing its own nuts and by importing nuts to process from other countries. The Vietnamese government is spending heavily to introduce high-tech strains into production in order to improve both quantity and quality. Vietnamese exports are of high quality and so the country's exporters are not only targeting India's largest export market, the United States, but also emerging markets such as China, Saudi Arabia and Russia. If Vietnam's growth in exports continues at the same rate, it will surpass India as the largest exporter by 2010.

There is potential for an excess supply of cashew nuts, which might result from plantation techniques and improved technology in India and elsewhere. To find outlets for a possible nut glut, the All-India Coordinated Spices and Cashew Nut Improvement Project has focused its efforts on increasing nut sales in small markets and on finding new markets for products from the cashew tree. For example, experimentation is going on to harvest both the fruit and the nut. The fruit is also being studied for commercial use in candy, jams, chutney, juice, carbonated beverages, syrup, wine and vinegar. Another area of research

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is in the use of cashew nutshell liquid (oil), which was once discarded as a waste product. It is now used extensively in industrial production of friction dusts, for formulation in brake linings and clutch facings. However, the extraction of cashew nutshell liquid has been too costly, to make the product fully competitive with some other types of oils. There is also a potential for short-term cashew shortages, such as that occurred in 1999, because of unfavourable climatic conditions. This has led India to try to increase its production and its foreign supplies.

Questions

1. What trade theories help to explain where the cashew tree products have been produced historically?
2. What factors threaten India's future competitive position in cashew nut production?
3. If you were an Indian cashew processor, what alternatives might you consider to maintain future competitiveness?

Source: John D. Daniels, Lee H. Radebaugh & Daniel P. Sullivan, "*International Business*", 11th ed., Pearson Education, p.217-219.

2.7 Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- This unit has reviewed a number of theories that explain why it is beneficial for a country to engage in international trade and has explained the pattern of international trade that we observe in the world economy.
- We have seen how 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 prevent exports through subsidies and to limit imports through tariffs and quotas.
- In explaining the pattern of international trade, we have seen 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 and Porter's theory of national competitive 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 national demand.

2.8 Keywords

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.

Comparative Advantage: The theory that countries should specialize in the production of goods and services they can produce more efficiently. A country is said to have a comparative advantage in the production of such goods and services.

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Factor Endowments: A country is endowed with resources such as land, labour and capital.

Isocost Line: It is that line which shows the various combinations of factors which can be obtained at the same cost. It is also called budget line. It shows what possible combinations of factors a firm can obtain at the same cost. Isocost line also shows cost-ratio of the factors.

Isoproduct Curve: It is a curve that shows different possible combinations of two factors of production, like capital and labour, yielding the same amount of output.

Physical Criterion of Factor Abundance or Scarcity: It means that if in a country capital ratio is greater than labour as against another country, then it will be called capital intensive country.

2.9 Review Questions

1. "Mercantilism is a bankrupt theory that has no place in the modern world." Discuss.
2. Drawing on the theory of comparative advantage to support your arguments, outline the case for free trade.
3. What are the potential costs of adopting a free trade regime? Do you think governments should do anything to reduce these costs?
4. "If theories, like girls, could win beauty contests, the comparative cost theory would certainly rate high in that, it is an elegant logical structure". Discuss.
5. Critically explain comparative advantage theory of international trade.
6. Explain the comparative cost theory of international trade. What are its assumptions and limitations?
7. What are the main drawbacks of comparative cost theory of Ricardo? How can this drawback be removed?
8. Explain the modifications in the Ricardian Comparative Advantage Theory.
9. "The difference of factor endowments among the nations is the basis of international trade." Explain.
10. Product life cycle theory has always been a very "attractive theory" to many students. What do you think are reasons for it?
11. Many trade theorists argue that the primary contribution of Michael Porter has been to re-popularize old ideas, in new and more applicable ways. To what degree do you think Porter's ideas are new or old?
12. Discuss Income-Preference Similarity theory. What are the basic tenets of the theory?

Answers: Self Assessment

1.	(e)	2.	(d)
3.	(d)	4.	Mercantilists
5.	Adam Smith	6.	Endowment
7.	Physical	8.	Goods
9.	Capital	10.	Scarce
11.	Production	12.	Raymond Vernon
13.	Linder	14.	Technology-based
15.	Primary manufacturing		

2.10 Further Readings

Notes

Books

Cherunillam Francis, *International Business, Text and Cases 3rd, Edition, Prentice-Hall of India Private Limited*

Charles W.L. Hill, *International Business Competing in the Global Marketplace, 4th Edition, Tata McGraw Hill, Publishing Company Limited*

Salvatore, Dominick, *International Economics*, John Wiley and Sons, New York, Chapter 2 and 3.

Online links

http://www.uwf.edu/rsjoland/WEB%20POSTED%20FILES/6%20International%20Trade%20Theory%20A%202%2004.pdf

Notes

Unit 3: Cultural and Social Environment

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Objectives

After studying this unit, you should be able to:

- Describe the concept of culture
- Analyse the linguistic and culture
- Explain the various approaches of culture

Introduction

The word *culture*, from the Latin colo, *-ere*, with its root meaning "to cultivate", generally refers to patterns of human activity and the symbolic structures that give such activity significance Culture consists of specific learned norms based on attitudes, values, and beliefs, all of which exist in every society. Culture cannot easily be isolated from such factors as economic and political conditions.

Much has been written on the subject of culture and its consequences. Whilst on the surface most countries of the world demonstrate cultural similarities, there are many differences, hidden below the surface. One can talk about "the West", but Italians and English, both belonging to the so called "West", are very different in outlook when one looks below the surface. The task of

the global marketer is to find the similarities and differences in culture and account for these in designing and developing marketing plans. Failure to do so can be disastrous.

Terpstran (1987) has defined culture as follows:

"The integrated sum total of learned behavioural traits that are manifest and shared by members of society".

Culture, therefore, according to this definition, is not transmitted genealogically. It is not, also innate, but learned. Facets of culture are interrelated and it is shared by members of a group who define the boundaries. Often different cultures exist side by side within countries, especially in Africa. It is not uncommon to have a European culture, alongside an indigenous culture, say, for example, Shona, in Zimbabwe. Culture also reveals itself in many ways and in preferences for colours, styles, religion, family ties and so on. The colour red is very popular in the west, but not popular in Islamic countries, where sober colours like black are preferred.

Much argument in the study of culture has revolved around the "standardisation" versus "adaptation" question. In the search for standardisation certain "universals" can be identified. Murdock (1954) suggested a list, including age grading, religious rituals and athletic sport. Levitt (1982) suggested that traditional differences in task and doing business were breaking down and this meant that standardisation rather than adaption is becoming increasingly prevalent.

Culture, alongside economic factors, is probably one of the most important environmental variables to consider in global marketing. Culture is very often hidden from view and can be easily overlooked. Similarly, the need to overcome cultural myopia is paramount.

3.1 Cultural Environment

When doing business abroad, a company first should determine whether a usual business practice in a foreign country differs from its home-country experience. Understanding the cultures of groups of people is useful because business employs, sells to, buys from, is regulated by, and is owned by people.

3.1.1 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.

Norms are the social rules that govern people's actions toward one another. Norms can be divided further into two major categories: folkways and mores. Folkways are the routine conventions of everyday life. Generally, folkways are action of little moral significance. Rather, folkways are social conventions concerning things such as the appropriate dress code in a particular situation, good social manners, eating with the correct utensils, neighbourly behaviour and the like. While folkways define the way the people are expected to behave, violation of folkways is not normally a serious matter. People who violate folkways may be though 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.

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 certain 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 as to what is perceived as mores.

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3.1.2 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. However, 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.

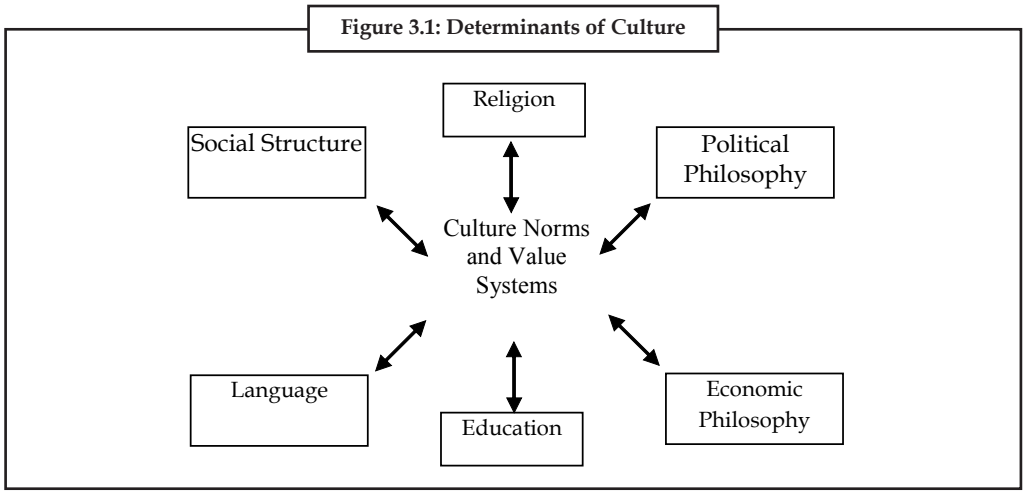
At the other end of the scale, we can speak of cultures that embrace several nations.

3.1.3 Determinants of Culture

The values and norms of a culture do not emerge fully formed. They are the evolutionary product of a number of factors, including the prevailing political and economic philosophy, the social structure of a society and the dominant religion, language and education (see Figure 3.1).

We will discuss the influence of social structure, religion, language, and education. 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.

Figure 3.1: Determinants of Culture



3.1.4 Social Structure

A society's "social structure" refers to its basic social organizations. 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, while 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) while 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 shred 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 behaviour. Human social life is group life. Individuals are involved in families, work groups, social groups, recreation 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. In some societies, individual attributes and achievements are

viewed as being more important than group membership, while in other societies the reverse is true.

Individual

Individualism is more than just an abstract political philosophy but 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 achievements. 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.

Individualism also finds expression in a high degree of managerial mobility between companies, and this not always a good thing. 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. The emphasis on individualism may also make it difficult to build teams within an organization to perform collective tasks.

Group

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

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 is the norm in certain sectors of the Japanese economy.

Social Stratification

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 and 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 such as better education, better health, a better standard of living and better work opportunities, than individuals born into a stratum towards the bottom of the hierarchy. Although all societies are stratified to some degree they differ in two related ways that are of interest to business organization. First, they differ from each other with regard to the degree of mobility between social strata and second, they differ with regard to the significance attached to the 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 the 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 position is usually not possible during an individual's lifetime. Often a caste position carries with it a specific occupation like shoemakers, butchers etc. These occupations are embedded in the caste and passed down through the family to succeeding generations. Although the number of societies with caste system has diminished rapidly during the 20th century, one partial example

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still remains. India has four main castes and several thousand sub-castes. Even though the caste system was officially abolished in 1949 it is still a powerful force in rural Indian society where occupation and marital opportunities are still partly related to caste.

While many societies have class systems, social mobility within a class system varies from society to society.

Significance Attached to the Social Strata in Business Contexts

From a business prescriptive 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 extreme emphasis on individualism limits 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.

Religious and Ethical Systems

Religion may be defined as a system of shared beliefs and rituals that are 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 behaviour. Most of the world's ethical systems are the product of religions. Thus we talk about Christian ethics and Islamic ethics.

The relationship between religion, ethics and society is subtle, complex and profound. Among thousands of religions in the world today, four dominate Christianity, Islam, Hinduism and Buddhism. Perhaps the most important business implications of religion centre on the context to which different in religions shape attitudes toward work and entrepreneurship and the degree to which religious ethics affect the costs of doing business in a country.

Did u know? From business point of view, society stratification is very significant in the success of any business.

3.1.5 Language

One way in which countries differ is the means of communication i.e. the language-spoken and the unspoken. Language is one of the defining characteristic of a culture.

Spoken Language

Other than communication language also structures the way we perceive the world, its certain features. For example the English language has one word for snow; the language of the Inuit (Eskimos) lacks a general term for it. Instead the different forms of snow is so important in their lives they have 24 words that describe different types of snow (e.g. powder snow, falling snow, wet snow, drifting snow).

Because language shapes the way perceive the world, it also helps define culture. In countries where there are more than one language, one also often finds more than one culture. Canada has an English-speaking culture and a French-speaking culture Tensions between the two 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 countries.

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Notes The primacy of the value of group identification also discourages managers and workers from moving from company to company.

Unspoken Language

Unspoken language refers to non-verbal 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 failure of communication. For example, making a circle with a thumb and the forefinger is a friendly gesture in the United States, but it is a vulgar sexual invitation in Greece and Turkey.

Another aspect of non-verbal communication is personal space, which is the comfortable amount of distance between you and someone you are talking to. 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 American unconsciously feel that Latin Americans are invading their personal space and can be seen backing away from them during a conversation. In turn, the Latin American may interpret such backing away as aloofness. The result can be a regrettable lack of rapport between two business people from different cultures.

3.1.6 Education

Formal education plays a key role in a society. It 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 grading system also teaches children the value of personal achievement and occupation.

From an international business perspective, one important aspect of education is its role as a determinant of national competitive advantage. The availability of a pool of skilled and educated workers seems to be a major determinant of the likely economic success of 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 the type of promotional material that should be used.

3.1.7 Demand Conditions

Composition of home demand, the size and pattern of growth of home demand.

1. ***Gross National Product (GNP):*** Broadest measure of economic activity which is defined as the market value of final goods and services newly produced by domestic factors of demand.

Notes The production by domestic factors could take place at home or abroad.

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2. ***Gross Domestic Product:*** Measures the value of production that occurs within a country's borders without regard to whether the production is done by domestic or foreign factors of production.

3. ***Per Capita GNP:*** Low-income ($725 or less), Mozambique ($80)

   Middle-income ($726-$8,955) Colombia ((2,140) High-Income ($8,956 or more)

   Example: Luxemburg (45,360)

   Japan (40,940)

   U.S. (28,020)

   Low- and middle-income countries is where the vast majority of the world's population lives

   North-South Dialogue

4. ***Relative Importance of High-income Countries:*** They represent only 21% of the number of economies and 15.2% of the population, but they generate 79.5% of the world's GNP.

5. ***Relative Importance of Middle-income Countries:*** They represent 28.1% of the world's population, 15.6% of its GNP, and represent 48.3% of the total countries.

6. ***Relative Importance of Low-income Countries:*** Account for 30.6% of the number of economies in the world, 56.7% of the population, but only 4.9% of the GNP.

7. ***Purchasing Power Parity (PPP):*** The basic idea is to identify the number of units of a country's currency required to buy the same amounts of goods and services in the domestic economy as one dollar would buy in the U.S. Thus, even though per capita GNP is the primary measure of wealth in a country, purchasing power GNP is an alternative way to measure wealth that is more indicative of the purchasing power of a country's currency.

8. ***Structure of Production:*** Percentage of GDP generated by agriculture, industry, manufacturing, and services.

   The key is to note that as income rises, the percentage of GDP devoted to agriculture falls, and the percentage devoted to services rises.

Other Indicators

Quality of Life: Life expectancy, educational standards, individual purchasing power, health, sanitation, and treatment of women are some factors indicating quality of life.

Social and cultural aspects of a society form its very nature. As "culture" is the essence of a society, this unit will concentrate on a discussion of it only. Of all the so called "environmental uncontrollables", culture, or at least the study of it, is one of the most difficult to comprehend, take account of and harness to advantage. This is particularly so when the product or service is "culture bound". Such products and services include those which are generally indigenous by nature and/or of relatively small value and very common. This is particularly true of foodstuffs. Sadza in Zimbabwe, a staple food made from maize meal, would not go down well in Beverley Hills, California. Neither would Middle Eastern sheep's eyes menus. Products of a more technical nature, like computers, on the other hand, have a universal appeal.

Caution Culture is a broad phenomenon which tends to affect the position of any products or services prevailing in the market.

However there is plenty of evidence to suggest that, with shrinking communications and with more people than ever travelling, even the most culture bound product or service can, and is, finding a world market niche. So even the infamous Veldschoen footwear of the South African pioneers has found its way into most corners of the world.

Self Assessment

State whether the following statements are true or false:

1. The emphasis on individualism may make it easy to build teams within an organization to perform collective tasks.
2. The primacy of the value of group identification also encourages managers and workers from moving from company to company.
3. The integrated sum total of unlearned behavioral traits that are manifest and shared by members of society.
4. Formal education does not play a key role in a society.
5. Religion may be defined as a system of shared beliefs and rituals that are concerned with the realm of the sacred.
6. Because language shapes the way perceive the world, it also helps define culture.
7. One way in which countries differ is the means of communication i.e. the language-spoken and the unspoken.

3.1.8 Language and Culture in India's Foreign Policy

Indian Struggle for Recognition

As an independent political nation, India was still very young, when it assumed the leadership of the newly emerging Afro-Asian nations. The leadership slipped from its hands, when its rhetoric of peace did not match with its own performance, both domestic and international; its foreign policy failed to perceive the changes taking place in the economic front all over the world. The policy became a list of clichés. Smaller and less prosperous nations, with equally tradition-bound societies, soon reaped great advantages by focusing more on the economic content in their policy than on high sounding moralistic declarations. India came to realize only much later that without a sound economic base of its own, its pretensions to leadership will be just what these were—mere pretensions.

To recapture the imagination of the West, India's foreign policy became more and more a cultural policy, with greater interest shown in the cultivation of the protest academics, protest politicians, and moralistic philosophers. It made an alignment with the emerging New Age performers in the sphere of religions and personal life styles, much to India's detriment, and to the dismay of the ever-increasing ranks of the conservatives in the West.

The shift in the geopolitical balance, which began with the growing rift between the Soviet Union and China, and the entry of China as a major international power caused the most crucial and disadvantageous turn in India's foreign policy. India's preoccupation with its geographical integrity (deeply impressed in the collective consciousness of India by the partition of British India into Republic of India and Pakistan) came to haunt and guide Indian foreign policy. The elitist Indian politician, brought up in the Fabian tradition, easily identified the utmost national interest of preserving India's geographical integrity with his bias for socialism, which easily led to India being the leading supporter of the Soviet Union. India was soon perceived to be mouthing what Soviet Union wanted it to say. Americans began to see that India was rather simply sanctimonious.

Notes

From the state of being ignored by the US and its allies, in 1980s, India became an orphan in early 1990s. The death of Rajiv Gandhi and the consequent weakening of the Nehru legacy coincided with the fall of the Soviet Union. India's preoccupation with preserving its geographical integrity, with brokering world peace and with the celebration of egalitarian ideals and protest thought had not led her anywhere. In fact, she is presently facing the hardest of all challenges from within, from Kashmir. However, people at large have always been behind the leadership in fostering, preserving, and moulding the geographical integrity of the nation. This was not necessarily a product of the foreign policy.

At long last, along with fear and despair, India seems to be waking up to face the reality and to make amends through a foreign turn, a turn which while retaining some clichés yet, is willing to break new grounds. The evidence for it is seen in the sweeping changes in its economic policies. Its tilt towards the West, especially towards the India, is more pronounced. And this has infuriated the leftists and hard-core nationalists within the country.

Did u know? Indian foreign and business policies were always inclined towards Soviet Union and with its fall, India had a big lacuna to fulfill.

Similarity of Political Institutions: No Guarantee for Recognition

Since its independence in 1947 from Britain, India has tried to follow a foreign policy which it considered would be truly characteristic of its independence, a policy which would bestow upon it the status of a big power and preserve its geographic integrity, even as this policy would lead to an equitable world both for the common man and the poor nations. India offers an excellent example of how poor nations, full of ambitions and pretensions to leadership, wanted to manipulate the world around them in their terms by assuming moralistic positions and how these failed miserably in a world of power politics. India was soon seen to be a staunch apologist for former Soviet Union. Whereas China with its communist label still intact was and is able to sail smoothly with the nations of the democratic West, India continues to be at a disadvantage, proving the point that similarity in the nature of political systems does not necessarily guarantee success in foreign relations. India is trying to make amends for its "faults" of the past through a sweeping and dramatic economic turn in its foreign policy content. Will this foreign turn in economics result also in a real change in the rest of its foreign policy?

Since the advent of the NDA Government in India, there are discernible changes taking place in Indian foreign policy. Yet one also continues to notice the inflexible and cliché-ridden policies as in the past.

Nehru's Idealism and British Legacy as Elements of Indian Foreign Policy

The foreign policy of independent India has been influenced more by Nehru's idealism and thinking than by practical ends in the past. The resolutions and declarations of the Congress leadership in general, and Jawaharlal Nehru in particular, have shaped the contours of Indian foreign policy. However, the elements of the Indian foreign policy are not totally original. Just as the Indian Constitution owes several of its essential features to the succeeding proposals of the British India Government, the current foreign policy, in its various manifestations and demands, takes its cues from the stated and unstated foreign policy declarations of the British India government.

Did u know? During the period of British domination, India's relations with its neighbours were ultimately determined by the needs of British imperialism.

Notes

Territorial Integrity

A Desire to have a grand Indian nation motivated some of the declarations of the Indian National Congress as regards its foreign policy. For example, whereas in 1885 the Indian National Congress opposed the annexation of Upper Burma with British India, in late 1920s it opposed the de-annexation of Burma from British India. By this time the foreign policy ideas of the Indian National Congress, the vanguard of Indian freedom struggle, looked towards a greater Indian nationhood.

3.1.9 Religion and Religious Groups

The role of religion in India's foreign policy cannot be exaggerated. Hindus claim to be the most tolerant of all religious groups. But this claim has been continuously shattered, resulting in certain adverse reactions among various nations. Secondly, India has to come to grapple with the fact that Hinduism is more or less a single nation religion, whereas Islam, Christianity and Buddhism are religions practiced and encouraged in many and diverse nations. The view the practitioners of other religions hold regarding Hinduism and Hindus certainly influences the foreign policy of these nations towards India. India's insistence on its secular credentials may be appreciated in the academic circles all over the world, but India continues to be a Hindu-majority nation, a Hindu nation, in the minds of lay Christians, Muslims, and Buddhists all over the world. The foreign policy formulations of other nations do not fail to recognize that India is a Hindu nation, despite India's claims to the contrary. Not only the fundamentalist turn in Islamic countries but also the conservative orientations in the Christian West look at the alliance between the New Age Movements and Hinduism with great suspicion.

Religion and Cultural as Vehicles of Foreign Policy

Culture has been a great tool and strength of India's foreign policy right from its independence in 1947. However, this culture policy has never touched the hearts of the ordinary men and women in other nations. Only a small number of people in the western societies (who could be extra ordinary people, but without much impact on foreign policy administrators in those nations) found Indian culture attractive. More often than not, culture was seen closely associated with religion, and other social systems such as marriage and eating habits, and this association has brought adverse notices in the minds of the vast majority of people in other nations. India's culture policy was aimed at the people of Hindu diaspora on the one hand, and at the academically oriented and protest minded fringes of other nations, on the other. The policy was successful in revitalizing the cultural moorings of the diaspora, but it did not derive any benefit from the latter. Even the traditionally friendly southeast Asian Buddhist nations (a friendship based on an appreciation of and admiration for the Hindu roots of Buddhism) soon preferred an economic orientation in their relations. Culture and religion still remain a great possibility, if India could establish a much better image for its internal affairs and economic capability. It is often forgotten that Hinduism and Buddhism are two distinct religions and that the Buddhist masses in the Buddhist nations may look at the Hindus and Hinduism entirely from a different angle.

Notes Culture has been a great tool and strength of India's foreign policy right from its independence in 1947.

Task Determine the approximate of languages spoken and studied in India.

Notes

3.1.10 Language and Linguistic Groups

The domestic language policy of India is geared towards a progressive shrinking of the use of English, a great beneficial legacy left by the British. In tandem with its religion and culture postures, the Indian foreign policy tried to promote the study of Indian languages abroad. This was a direct emulation of the British, French, German and Soviet policies. Once again there was some success, but this success was limited to the fringes of Western societies. On the other hand, the domestic language policy in support of a national language has been incorporated as an element of India's foreign policy in its attempt to include Hindi as one of the UN official languages, and to strengthen the ethnic identity of the Indian diaspora.

Again and again, India exhibits a burning desire to seek acceptance and recognition as a great power, but its claims are expressed through weak and misplaced instruments. The ancient nature of a civilization, expressed through continuity in religion, culture and language, does not bestow upon any nation great power. Past achievements are no guarantee for the future status of preeminence. And yet India can still exploit the growing desire among ordinary Indians to learn and master English to its advantage in the free market world. Thus the role of language in its foreign policy is not diminished, but it needs to be carefully worked out, especially with the changes towards a free market economy.

Linguistic Groups

Religion provides the best insight into a society's behavior and helps answer the question why people behave rather than how they behave.

A survey in the early 1980s revealed the following religious groupings (see Table 3.1).

Table 3.1: Religious Groupings

Groups	Million
Animism	300
Buddhism	280
Christianity	1500
Hinduism	600
Islam	800
Shinto	120

Religion can affect marketing in a number of ways:

1. Religious holidays - Ramadan cannot get access to consumers as shops are closed.
2. Consumption patterns - fish for Catholics on Friday;
3. Economic role of women – Islam;
4. Caste systems - difficulty in getting to different costs for segmentation/niche marketing;
5. Joint and extended families - Hinduism and organizational structures;
6. Institution of the church - Iran and its effect on advertising, "Western" images;
7. Market segments - Malaysia - Malay, Chinese and Indian cultures making market segmentation;
8. Sensitivity is needed to be alert to religious differences.

Notes

Caution Though India is all set to welcome and utilise the power of English language since a longtime. It had not taken a set back in promoting the study of Indian languages abroad.

3.1.11 Attitudes and Values

Values often have a religious foundation, and attitudes relate to economic activities. It is essential to ascertain attitudes towards marketing activities which lead to wealth or material gain, for example, in Buddhist society these may not be relevant.

Also "change" may not be needed, or even wanted, and it may be better to relate products to traditional values rather than just new ones. Many African societies are risk averse, therefore, entrepreneurialism may not always be relevant. Attitudes are always precursors of human behaviour and so it is essential that research is done carefully on these.

Self Assessment

Fill in the blanks:

8. The word culture, derived from the Latin color, with its root meaning ..... .
9. Material culture refers to tools, artifacts and ..... .
10. ..... refer to the ideas in a culture concerning beauty and good taste as expressed in the arts – music, art, drama and dancing and the particular appreciation of colour and form.
11. ..... often have a religious foundation, and attitudes relate to economic activities.
12. The role of religion in India's foreign policy cannot be ..... .
13. ..... claim to be the most tolerant of all religious groups.
14. ..... has been a great tool and strength of India's foreign policy right from its independence in 1947.
15. The domestic language policy of India is geared towards a progressive shrinking of the use of ..... .

3.1.12 Socio-cultural Factors and International Marketing

Multinational corporations operate in different host countries around the world and, in doing so, they have to deal with a wide variety of political, economic, geographical, technological and marketing situations. Moreover, each host country has its own society and culture which is different in many important ways from almost every other society or culture, although there are some commonalities. Though society and culture do not appear to be a part of marketing situations, yet they are actually key elements in showing how marketing activities will be conducted, what goods will be produced, and through what means they will be sold to establishing industrial and management patterns and determining the success or failure of a local subsidiary or affiliate.

Society and culture influence every aspect of overseas business of an MNC and successful MNC operations – whether it is marketing, finance, production, or personnel – have to be acutely aware of the predominant attitudes, feelings and opinions in the local environment. Differences in values and attitudes between the management and the parent offices and expatriate managers at the subsidiary or affiliate level and local managers and employees can lead to serious operational and functional problems, which arise not because there are individual problems, but because of the important differences between societies and cultures. Society and culture often mould general

Notes

attitudes towards fundamentals of life such as time, money, productivity and achievement, all of which can differ widely across countries and lead to situations of differing expectations between the management in the home office and local employees of subsidiaries and affiliates.

While some socio-cultural differences are obvious, others are relatively subtle, though equally important. It is often difficult for an international manager to catch on these subtle differences if he or she has not lived or worked in cultures other than that of the home country.

MNCs have realised, sometimes through costly blunders, that socio-cultural factors are vital ingredients that make up the overall business environment and that it is essential to appreciate these differences and how they influence the business before an attempt is made to set up an operation in a host country.

Notes Society and culture influence every aspect of overseas business of an MNC and successful MNC operations – whether it is marketing, finance, production, or personnel – have to be acutely aware of the predominant attitudes, feelings and opinions in the local environment.

Case Study

Seventh Heaven

If there is one thing William H. Pinckney, Managing Director and CEO, Amway India, has mastered during his seven year stay in India, it's the art of breaking the coconut in one go. He has had enough practice at the opening of every new branch office and during the annual Diwali puja in office, which is an Indian tradition followed religiously at Amway.

From wearing a kurta pyjama, to eating local food, Pinckney has taken to India and things Indian. Even his office has shades of Indian influences, including a bronze Ganesh statue. "My wife and I had always talked about an adventure and to us, India was the ultimate adventure," says Pinckney.

The Pinckney affair with 1ndia started in late 1997, when Amway sent them for a typical look-see, to decide whether they could contemplate living here for some two-odd years. They spent a week in Delhi just 'getting a feel for living in the capital city'. "Before I came here, I had heard a lot of stories, and none of them were good." What didn't help matters, was the number of vaccinations he had to take before coming to India. "I had never had as many shots in my life before," says the only expatriate on the rolls of ₹ 600-crore Indian operations of Amway.

Cleanliness and health were two issues; the Pinckney's were concerned about. But, to their immense relief, it turned out to be far better. "We have not taken any malaria pills in the last five years." People were the first thing Pinckney noticed on his arrival to India. "In Sydney, you don't find people on the roads, just outside the city. Here, they are everywhere." What has impressed him most about Indians, is the level of education, dedication and commitment, which he says, is 'the best and the highest in the world'.

Professionally, the HR aspect of working in India has been most interesting, 'a learning curve' for him. "Coming out of the West, one was used to giving direct feedback. But in India, you have to be very careful about that. Constructive criticism has to be applied very carefully."

Contd...

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Another interesting observation he made, was regarding performance appraisal. "People here equate hard work with high performance. Just because you spent as many hours, it does not make you a high achiever." Pinckney himself works almost every Saturday, if he is in town and dislikes taking work home to his lovely house, in the plush Sainik Farms locality, in the outskirts of Delhi. While both husband and wife tend to stay in more, dining out with friends is one of the few entertainment options available in India. He has got more Indian friends than expats, mostly people he met through business, like Kanwar Bhutani of Tupperware.

Both, however, try to find time to play golf at the ITC Golf Course in Gurgaon. It's a game Mrs. Pinckney took up in India, since she found free time on her hands, for the first time in her life. A certified chartered accountant, Mrs. Pinckney used to run her own business in Australia. Some of that time has been used to learn to cook typical Indian food, butter chicken, aloo palak, rogan josh and dal makhani. It's no wonder then that half their meals are Indian. They've adjusted to the spice factor in Indian food. What was hot when they first came is nothing compared to hot today. "When we travel abroad, we really miss the spices."

After all this time in India, they still find it striking that irrespective of which part of the country they are in, there's a positive spirit about the people of India. People have hope, optimism and are generally happy. The respect Indians have for their culture and beliefs is another factor that the Pinckney's appreciate.

"Family ties are much stronger here, as is, respect for elders and their wisdom for instance, girls in our office who talk and dress in a Western way, have no problems accepting arranged marriages", says Pinckney.

Pinckney's gave a grand Indian reception after their daughter's Australian wedding, including traditional attire for the bride and groom. "Yet another occasion to break a coconut, Mr. Pinckney?" we wonder.

Questions

1. How could William H. Pinckney acculturate himself in India?
2. What lessons can Pinckney convey to similar expatriates?

3.2 Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- Culture is a complex whole that includes knowledge beliefs, art, morals, law, customs and other capabilities acquired by people as members of society.
- Values and norms are the central components of a culture. Values are abstract ideals about what a society beliefs to be good, right and desirable. Norms are social rules and guide lines that prescribe appropriate behavior in particular situations.
- Values and norms are influenced by political and economical philosophy, social structure, religion, language and education.
- The social structure of a society refers to a basic social organization. Two main dimensions along with social structures defer are the individual – group dimension and the stratification dimension.
- 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 a building block of social organizations. These societies emphasize group membership and group achievements above all else.

Notes

- All societies are stratified into different classes. Class conscious societies are characterized by low social mobility and high degree of stratification. Less class conscious societies are characterized by high social mobility and low degree of stratification.
- Religion may be defined as a system of shared beliefs and rituals that is concerned with the realm of the scared. Ethical systems refers to a set of moral principals or values that are used to guide and shape behaviour. The world's major religions are Christianity, Islam, Hinduism and Buddhism.
- Language is one defining characteristic of a culture. It has both the spoken and an unspoken dimension.
- Formal education the medium through which the individual learns skills and are socialized into the values and the norms of a society. Education plays an important role in the determination of national competitive advantage.
- Geert Hofstede studied how culture relates to values in the work place. Hofstede summarized four dimensions – power distance, uncertainty avoidance, individualism versus collectivism and masculinity versus femininity.
- Culture is not a constant; it evolves over time. Economic progress and globalization seem to be two important engines of cultural change.
- 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 behaviour.
- The value systems and norms of a country can affect the costs of doing business in that country.
- Although many ethical principles are universal, some are culturally bounded. What is not ethical in one country might be common in another. International business need to adhere to a consistent set of ethics derived from a high moral code.

3.3 Keywords

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 socio-economic achievements. Mobility between classes is possible.

Collectivism: An emphasis on collective goals as opposed to individual goals.

Confucian Dynamism is an acceptance of the legitimacy of hierarchy and the valuing of perseverance and thrift, all without undue emphasis on tradition and social obligations which could impede business initiative.

Cross-cultural Literacy: Understanding how the culture of a country affects the way business is practiced.

Culture: The complex whole that includes knowledge, belief, art, morals, law, custom, and other capabilities acquired by a person as a member of society.

Human Heartedness: Openhearted patience, courtesy and kindness.

Individualism: An emphasis on the importance of guaranteeing individual freedom and self-expression.

***Integration*:** Degree of tolerance, harmony and friendship a society endorses, at the expense of competitiveness: it has a "broadly integrative, socially stabilizing emphasis".

Notes

3.4 Review Questions

1. Describe the main elements of culture.
2. List the major approaches to the study of culture and show their relevance in international marketing citing examples.
3. How does Hofstede's approach to cultural differences aid the international marketer? Do you think his approach is reasonable and valid?
4. What is the relation between socio-cultural factors and international marketing?
5. How are culture, society and the nation state interrelated?
6. Write a short note on the determinants of culture.
7. Explain the role of language and culture in India's foreign policy.
8. "Language is one of the defining characteristic of a culture." Comment.
9. Describe 'in brief' the composition and conditions of home demand.
10. Write a short note on religion and religious groups.

Answers: Self Assessment

1.	True	2.	False
3.	False	4.	False
5.	True	6.	True
7.	True	8.	to cultivate
9.	technology	10.	Aesthetics
11.	Values	12.	Exaggerated
13.	Hindus	14.	Culture
15.	English		

3.5 Further Readings

Books

C.B. Gupta, *Business Environment.*

Francis Cherunillam, *Global Business Environment*.

M. Kapagam, *Environmental Economics.*

Philip R. Cateora, *International Marketing.*

Online links

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Notes

Unit 4: Technological Environment

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Objectives

After studying this unit, you should be able to:

- Define technology environment
- Describe the benefits of technology
- Explain the technology cycle

Introduction

Technology has played a major role in the life of people, right from snail mail to e-mail the way we live has dramatically changed from the past decade. Technology has removed the global barriers like distance, time etc thanks to the latest technological developments like Internet, e-mail, video conferencing, cell phone etc that plays a major role in international business.

4.1 Technological Environment

4.1.1 Benefits of Technology in Management Decision-making

The managerial decisions are of two types:

1. Structured or programmed decisions, and
2. Unstructured or non-programmed decisions.

Notes

Technology helps the manager to make decisions related to business in the following ways:

1. ***Decision Support System:*** It is an information system which collects the information from various sources like government, customers and suppliers and global market and competitors and helps the manager to interact with the mathematical decision models to make decision.
2. ***Group Decision Support System:*** An expert system with set of hardware, software and procedures that support a group of people engaged in a decision-related meeting.
3. ***Office Automation System:*** An office automation system uses computers or networks to carry out various office operations.
4. ***Transaction Processing System:*** A system that handles the processing and tracking of transactions is called TPS.
5. ***Management Information System:*** MIS is a set of software tools that enables managers to gather, organize, and evaluate information about a workgroup, department or entire organization.
6. ***Expert System:*** Expert system is a specialized application that performs tasks that would normally be done by a human.

Example: Medical diagnosis Credit History.

4.1.2 Communication Tools used in International Business

1. Video Conferencing
2. E-mail
3. Internet
4. Laptop
5. Cell Phone

Did u know? With the help of MIS, managers can gather, organise and evaluate information effectively and in short time.

4.1.3 Effect of Technology on Strategy and Competition

Some of them are discussed as under:

1. ***Creating Barriers to Entry:*** The cutting edge technology used by MNCs has created barriers for the new entrants into the industry and also caused a major threat to the domestic industries this has given rise to the increase in competition and importance for companies to invest in research and development.
2. ***Generating New Products:*** Technology has always created new to the world products and modified new products; there is a greater need for the business organizations to invest in large volumes in research and development to bring out new products. Some minor changes in features of the product with the same technology has given rise to new products.

Example: The modified features of the tape recorder has given rise to Walkman where both uses the same technology.

Notes

3. ***Changing Relationships with Suppliers:*** The relationships maintained by the suppliers have dramatically changed from traditional procurement to e-procurement, e-supply chain management, global integration etc. which has given rise to quality, efficiency, of production in less time.

4. ***Changing the Basis for Competition:*** Technology has formed as a main basis for competition, the superior technology used by the business firms has resulted in improved quality of producing goods, improved efficiency by automation and mechanization, Total Quality Management (TQM).

Note Expert System is a specialized application that performs tasks that would normally be done by a human. Ex: Medical diagnosis Credit History.

Self Assessment

Fill in the blanks:

1. Some Communication Tools used in International Business are ....., ... and ..... .
2. Group Decision Support System is a system with set of ....., ... and ..... that support a people occupied in a decision-related meeting.
3. The relationships maintained by the suppliers have changed from ..... procurement to ..... procurement

4.1.4 Features of Technology

The following are the features of technology:

1. ***Technology Brings Change:*** Technology brings change in every walk of life, like the way we cook, the way we commute, the way we communicate etc. technology has brought lot of changes in business from barter system to e-business.
2. ***Technology Reduces Time:*** Technology has drastically reduced time between conceiving an idea and implementing that idea. The world has become a global village, which has no barriers by the invention of internet technologies which has reduced time of transferring information in no time.
3. ***Technology Reduces Distance:*** With the invention of advanced transportation systems which has reduced the time to travel e.g, by the invention of supersonic jets etc.
4. ***Technology Improves Quality of Life:*** The quality of life of people has definitely improved, the advancements of medical technology the life expectancy rate are increased and the control of various diseases is possible.

4.1.5 Diffusion of Technology

Diffusion is a process of spreading, if a bottle of perfume is opened the molecules will diffuse in the entire atmosphere similarly the technology will diffuse in the following ways:

1. ***Joint Ventures:*** Two companies A and B can jointly work on a venture for a certain period by exchanging technology, human resources etc.
2. ***Licensing:*** Companies in the domestic market can produce the produce the products by license permission from MNCs.

Notes

Example: Coca-Cola are produced in India by the way of license.

3. ***Technological Transfer:*** Technology can be transferred from on country to another by way of collaboration many times we hear terms like German collaboration, Japanese collaboration etc.

Example: Maruti Suzuki is collaboration between Maruti Udyog of India and Suzuki motors of Japan.

4.2 Technological Cycle

The technological cycle is an organized way to develop technology:

Phase 1 – Need Analysis: Defining the problem and deciding weather to proceed and analyzing the current system in depth and developing possible solutions to the problem and selecting the best solution and defining its function.

Phase 2 – Designing Technology: The project team describes how the selected solution will work. Each system activity is identified.

Phase 3 – Development of Technology: It includes creating or customizing the technology for various parts of the system. There two alternative paths:

1. Acquisition,
2. Local development

Technical and user documentation is written testing is also integral part of this phase

Phase 4 – Implementation of Technology: The technology is installed in the user environment.

Phase 5 – Maintenance of Technology: Training and support to the users of technology, improvements to the technology are made regularly during the remaining cycle.

Self Assessment

Fill in the blanks:

4. The technological cycle is an organized way to develop ..... .
5. ..... is a set of software tools that enables managers to gather, organize, and evaluate information about a workgroup, department or entire organization.
6. A system that handles the processing and tracking of transactions is called ..... .
7. ..... in the domestic market can produce the produce the products by license permission from MNCs.
8. Technology has drastically reduced time between conceiving an idea and ..... that idea.
9. The world has become a ....., which has no barriers by the invention of internet technologies which has reduced time of transferring information in no time.
10. ..... is a process of spreading.
11. The ..... describes how the selected solution will work.
12. ..... includes creating or customizing the technology for various parts of the system.

Notes

4.3 Business Implications of Technology

1. Launch new products and services to your sales force without taking them out of the field.
2. Highlight introductions and product releases to employees, shareholders, and clients.
3. Provide certification programs to geographically dispersed audiences.

Notes Training and support to the users of technology, improvements to the technology are made regularly during the remaining cycle.

Task Should the technological and enhancement be taken into consideration time to time product enhancements?

Need Designing Implement at Develop and Maintenance

- Conduct focus group sessions to help bring products to market faster.
- Create personalized sales presentations for your customers and reduce timely sales cycles.
- Provide a simple but effective way to get more out of training sessions by giving your audience something for their eyes as well as their ears.
- Great for Human Resources departments to get out information about policy and procedure changes. Ideal for new employee orientations and employment interviews.

Did u know? In business, technology can be shared and transferred through collaboration.

Caution Technology can be a great factor of competitive advantage for any business.

Case Study

Chlorofluorocarbon (CFC) Taxes at Distributor Inc.

Introduction

Distributor Inc. was one of the largest independent chemical distributors in the United States. Distributor purchased chemicals in large quantities from chemical companies, repackaged them in smaller quantities from chemical companies, repackaged them in smaller quantities, and shipped those smaller units to small- and medium- sized businesses that used them. Distributor Inc. did not manufacture any chemicals on its own.

Chlorofluorocarbons (CFCs)

One chemical that Distributor shipped was Freon. The company bought Freon from chemical manufacturers and sold it to firms that used it in manufacturing processes. Freon

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was one of several chlorofluorocarbons with wide commercial use. In the mid-1980s, convincing scientific evidence indicated that increased levels of CFCs in the atmosphere were decreasing stratospheric ozone concentrations. The ozone layer of the atmosphere absorbs ultraviolet.

Declining stratospheric ozone concentrations allow more ultraviolet light through, which could lead to costly social effects worldwide.

Increased CFC levels in the atmosphere were attributed to Freon leakage and evaporation from individually owned appliances and commercial equipment. Consequently, a phase out of manufacture and use was called for by the 1987 Montreal Protocol on Substances that Deplete the Ozone Layer. The Protocol, and subsequent Amendments, set ambitious goals to reduce CFC production, but allowed individual governments the freedom to determine how they would meet those targets.

In 1990, the United States began taxing CFC manufacture (and providing tax incentives for recycling) under the federal Fluorocarbon Tax (IRC §4681). For Freon, the tax was initially set at $1.37/pound (which is almost equal to the pretax wholesale price of the product). The tax was paid by the Freon manufacturer, then the cost was passed on to Distributor Inc., which in turn passed the cost on to its customers. The legislation also stipulated that the tax would increase incrementally each year.

Reaction to the Tax

As was common for many businesses, Distributor.s accounting system did not have the ability to separate a wholesale unit cost into different components (e.g., product, cost, exclusive of product tax). Typically, when Distributor received a shipment from a producer, it recorded the shipment identification number, substance identity, unit cost, and total number of units. Then, different accounting systems added various information to the wholesale cost as each value-added step was completed (e.g., repacking, invoicing for transport). Output from each of these systems was used to generate financial accounting reports, managerial accounting reports, and tax return data.

Distributor's customers who used Freon were unhappy with the increase in price. Some customers were (unfairly) suspicious that Distributor had used the tax increase as an opportunity to quietly increase its profit margins for Freon. These customers demanded a breakdown of non-tax product cost and product tax on Distributor invoices.

Distributor's executives were concerned that its business would be affected by the Fluorocarbon Tax, even though the company did not explicitly have to pay the tax.

Case Questions and Assignment

Be prepared to discuss: (a) from a policy perspective, what economic effect was probably expected from implementing this pass-through tax, (b) what is the likely impact of the Fluorocarbon Tax on Distributor's customer relationships, (c) how is the Fluorocarbon Tax likely to impact Distributor's cost accounting results, (d) what other impacts may the tax have on Distributor, and (e) is this tax unique, or are there other taxes or regulatory instruments that pose analogous problems for business.

Source: www.BELLinnovation.org.

4.4 Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- Technology has played a major role in the life of people, right from snail mail to e-mail the way we live has dramatically changed from the past decade.

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- Technology has removed the global barriers like distance, time etc thanks to the latest technological developments like Internet, e-mail, video conferencing, cell phone etc that plays a major role in international business.

4.5 Keywords

Expert System: It is a specialized application that performs tasks that would normally be done by a human.

Skimming Price: The charging of a high price in order to gain maximum revenue conducted under conditions of product uniqueness and inelastic demand patterns.

Sourcing: A decision to have certain components in the value chain manufactured out of the country often called the "make of buy" decision.

Standardization: Same goods or services marketed in either product, distribution or advertising form, unchanged in any country.

Standardized Plans: A uniform planning system applied globally, based on economics of scale and consumer uniformity.

Strategic Business Unit: A self contained grouping of organizations, products or technologies which serve an identified market and competes with identified competitors.

4.6 Review Questions

1. What are the features of technology?
2. What is the technology implication of business?
3. What are the benefits of technology in management and decision-making?
4. "Technology has drastically reduced time between conceiving an idea and implementing that idea". Comment.
5. List the various communication tools used in international business.
6. What are the effects of technology on strategy and competition?
7. Explain the concept of diffusion of technology.
8. Describe the different phases of technological cycle.
9. How is possible to transfer technology from one country to another?
10. "Superior technology used by the business firms has resulted in improved quality of producing goods, improved efficiency by automation and mechanization." Comment.

Answers: Self Assessment

1.	E-mail, internet, cell-phone	2.	Hardware, Software, procedures
3.	Traditional, electronic	4.	Technology
5.	MIS	6.	Transaction Processing System
7.	Companies	8.	Implementing
9.	Global village	10.	Diffusion
11.	Project team	12.	Development of Technology

4.7 Further Readings

Notes

Books

C.B. Gupta, *Business Environment.*

Francis Cherunillam, *Global Business Environment.*

M. Kapagam, *Environmental Economics.*

Philip R. Cateora, *International Marketing.*

Online links

http://www.csub.edu/~bbae/publication/ERP%20implementation%20%26%20implications.june%2004%20ISCJ.pdf

www.waset.org/journals/waset/v64/v64-210.pdf

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Unit 5: Political and Economic Environment

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Objectives

After studying this unit, you should be able to:

- Define political environment
- Explain the types of political systems
- Describe the government intervention in business

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Introduction

The critical concern Political environment has a very important impact on every business operation no matter what its size, its area of operation. Whether the company is domestic, national, international, large or small political factors of the country it is located in will have an impact on it. And the most crucial and unavoidable realities of international business are that both host and home governments are integral partners. Reflected in its policies and attitudes toward business are a governments idea of how best to promote the national interest, considering its own resources and political philosophy.

5.1 Political Environment

A government control's and restricts a company's activities by encouraging and offering support or by discouraging and banning or restricting its activities depending on the government. Here steps in international law. International law recognizes the right of nations to grant or withhold permission to do business within its political boundaries and control its citizens when it comes to conducting business. Thus, political environment of countries is a critical concern for the international marketer and he should examine the salient features of political features of global markets they plan to enter.

5.1.1 Sovereignty of Nations

From the international laws point of view a sovereign state is independent and free from external control; enjoys full legal equality; governs its own territory; selects its own political, social, economic systems; and has the power to enter into agreements with other nations. It is extension of national laws beyond a country's borders that much of the conflict in international business arises. Nations can and do abridge specific aspects of their sovereign rights in order to coexist with other countries. Like the European Union, North American Free Trade Agreement (NAFTA) are examples of nations voluntarily agreeing to give up some of their sovereign rights in order to participate with member nations for common, mutually beneficial goals.

The ideal political climate for a multinational firm is stable, friendly environment. Unfortunately, that is never really the case, it's not always friendly and stable. Since foreign businesses are judged by standards as variable as there are nations, the friendliness and stability of the government in each country must be assessed as an ongoing business practice.

Stability of Government Policies

The most important of the political conditions that concern an international business is the stability or instability of the prevailing government policies. Political parties may change or get reelected but the main concern for MNCs is the continuity of the set rules or code of behavior regardless of the party in power. A change in the government does not always mean change in the level of political risks. In Italy the political parties have changed 50 times since the end of World War II but the business continues to go on as usual in spite of the political turmoil. In comparison is India, where the government has changed 51 times since 1945 but however much of the government policies remain hostile to foreign investments. Conversely, radical changes in policies toward foreign business can occur in the most stable of the governments. Some of the African countries are among the unstable with seemingly unending civil wars, boundary disputes and oppressive military regimes. Like one of the region with the greatest number of questions concerning long-term stability is Hong Kong as since China has gained control, the official message is that nothing will change and thus everything is seemingly going smoothly but the political analysts say that it is too early to say how will the business climate change, if it will. If there is potential for profit and if given permission to operate within a country, MNCs

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can function under any type of government as long as there is some long-term predictability and stability.

Political Parties

Particularly important to the marketer is the knowledge of all philosophies of all major political parties within a country, since anyone might become dominant and alter prevailing attitudes. In those countries where there are two strong political parties where usually one succeeds the other, it is important to know the direction each of the parties is likely to take. Changes in direction a country may take toward trade and related issues are caused not only by political parties but also by politically strong interest groups and factions within different political parties, which cooperate to affect trade policies.

5.1.2 Types of Political Systems

The following are the types of political systems:

Democracy

Democracy is *for the people, by the people, and of the people,* its similar to participative management, in this system people are encouraged to participate in decision making, a peoples representative can be selected by the people through a process of election, and the responsibility of leading the nation is kept on the shoulders of the elected representative e.g, India.

Dictatorship

It is also called as authoritarianism, which is quite opposite to democracy, here the hole power is in the hands of the leader, and people should follow the leader, all the policies related to economy, business etc are governed by the leader e.g, Saudi Arabia.

5.1.3 Political Risks of Global Business

Some of the political risks of global business are mentioned below:

Confiscation

The most severe political risk is confiscation, which is seizing of company's assets without payment.

Expropriation

Which requires reimbursement, for the government seized investment.

Domestication

Domestication occurs when host country takes steps to transfer foreign investments to national control and ownership through series of government decrees. A change in the government's attitudes, policies, economic plans and philosophies toward the role of foreign investment is the reason behind the decision to confiscate, expropriate or domesticate existing foreign assets.

Assessing Political Vulnerability

Some products are more politically vulnerable than others, in that they receive more government attention. This special attention may result in positive or negative actions towards the company.

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Unfortunately there are no absolute guidelines for marketer's to follow whether the product will receive government attention or not.

Politically Sensitive Products

There are some generalizations that help to identify the tendency for products to be politically sensitive. Products that have an effect upon the environment exchange rates, national and economic security, and the welfare of the people are more apt to be politically sensitive. For products judged non essential the risk would be greater, but for those thought to be making an important contribution, encouragement and special considerations could be available.

Forecasting Political Risks

A number of firms are employing systematic methods of measuring political risk. Political risk assessment can:

1. help managers decide if risk insurance is needed,
2. devise and intelligence network and an early warning system;
3. help managers develop a contingency plan;
4. Build a database of past political events for use by corporate management; and
5. Interpret the data gathered and getting forewarnings about political and economic situations.

Reducing Political Vulnerability

Even though the company cannot directly control or alter the political environment, there are measures with which it can lessen the susceptibility of a specific business venture.

Good Corporate Citizenship

A company can reduce its political vulnerability by being a corporate citizen and remembering:

1. It is a guest in the country and should act accordingly.
2. The profits are not it's solely, the local employees and the economy of the nation should also benefit.
3. It is not wise to try and win over new customers by totally Americanizing them.
4. A fluency in the local language helps making sales and cementing good public relationships.
5. It should train its executives to act appropriately in the foreign environment.

Strategies to Lessen Political Risks

MNCs can use other strategies to minimize political risks and vulnerability.

They are:

1. Joint ventures,
2. Expanding the investment base,
3. Marketing and distribution,
4. Licensing,

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5. Planned domestication, and
6. Political payoffs.

5.1.4 Government Encouragement of Global Business

In this section, we will learn about the government encouragement of global business.

Foreign Government Encouragement

Governments also encourage foreign investment. The most important reason to encourage investment is to accelerate the development of an economy. An increasing number of countries are encouraging investments with specific guidelines toward economic goals. MNCs may be expected to create local employment, transfer technology, generate export sales, stimulate growth and development of the local industry.

National Government Encouragement

The US government is motivated for economic as well as political reasons to encourage American firms to seek opportunities in the countries worldwide. It seeks to create a favorable climate for overseas business by providing the assistance by providing the assistance that helps minimize some of the troublesome politically motivated financial risks of doing business abroad.

Majority of the MNCs have to face complex political environmental problems because they must cope with the politics of more than one nation. That complexity forces MNCs to consider three types of political environment: foreign, domestic and international.

The developing countries and the Least Developed Countries (LDCs) often view foreign firms and foreign capital investment with distrust and even resentment, owing primarily to a concern over potential foreign exploitation of local natural resources. Dependency Theory explains why Latin American countries are reluctant to welcome foreign-based MNCs. According to this theory, the ongoing economic, political and social transformations have made it necessary for Latin America to rely on the capitalistic system. Similarly, the parties which are inclined to the leftist thinking and *swadeshis* (indigenous usage thinking) are also reluctant to encourage MNCs to participate in the development of Indian industries in a big way fearing that they are able to extract surplus value from their less developed environment, thus, leaving them underdeveloped while perpetuating the existence of class conflicts and oppressive governments. However, MNCs should be allowed to operate in the highly technological sectors in which the countries have no know-how and Research & Development.

Developed countries are also quite concerned about foreign direct investments. Many Americans have expressed their concern that the increasing foreign ownership of American assets poses a threat to their country's national security both politically and economically. The inflow of foreign capital adds to the domestic capital stock. This activity contributes to the country's standard of living and enhances the country's ability to service its international indebtedness. As a result, the benefits of foreign investment outweigh the costs.

In some cases, the opposition to imported goods and foreign investments is based on moral principles. For example, the citizens of many nations pressurise the companies of their countries not to invest in South Africa because of that country's apartheid policy. Arabian countries, even now, do not participate in joint ventures in Israel because of their anti-Muslim policies.

Regardless of whether the politics is foreign, domestic or international, the companies should keep in mind that political climate does not remain stationary. For example, there had been a hostile climate in America against China in 1980s but now the reverse has happened. After decades as bitter enemies, both countries became very much interested in improving their political and economic ties so as to dilute the power of the erstwhile Soviet Union. Right from the partition

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between India and Pakistan, both the countries have fought three wars and the relations are strained to the extent of even using nuclear power in case of extreme emergencies. Now, with the movement of Bus from Delhi to Lahore and back in which both the prime ministers will be travelling, the tension seems to have been reduced and there is likelihood that both the countries will have a common nuclear programme and also sign a no-war pact in the near future.

Companies can derive positive economic benefits when the relationship between two countries improves or when the host government adopts a new investment policy. As in the case of India, the country was a highly regulated, closed economy, which discouraged foreign direct investment. It was only in 1991 that a new government began the reform programme, which could transform India into one of the world's most dynamic economies.

On the other hand, serious problems can develop when the political condition deteriorates. A favourable investment climate can disappear overnight. For example, the United States withdrew Chile's duty free trade status because of Chile's failure to take "steps to afford internationally recognised worker rights". Chile, thus, joined Romania, Nicaragua and Paraguay being suspended from the Generalised System of Preferences (GSP). The economic sanctions imposed by America, Japan and other European countries on India and Pakistan after they had exploded the nuclear devices is again unjustifiable. Prior to the explosions, both the countries, especially Pakistan, had very cordial economic and military relations with USA. Pakistan's economy is at the lowest ebb under the present sanctions.

5.1.5 Factors affecting Global Business

Political Risk Analysis

There are a number of political risks which are to be faced by international marketers. The risks, which the marketers face from the host government, are – confiscation, expropriation, nationalisation, domestication and creeping expropriation. Such actions are more likely to be levied against foreign investments though local firms are not totally immune. For example, Charles de Gaulle nationalised France's three largest banks in 1945 and more nationalisation occurred in 1982 under the French socialists.

Confiscation is the process of a government's taking ownership of a property without compensation. For example, the Chinese government seized American property after the Chinese communists took power in 1949. Occidental Petroleum Company, wanted the United States to review Venezuela's GSP eligibility after the country confiscated the company's assets without compensation.

Expropriation differs from confiscation in that there is some compensation though not necessarily just compensation. More often than not, a company whose property is being expropriated agrees to sell its operations – not by choice but rather because of some explicit or implied coercion.

Nationalisation involves government ownership and it is the government that operates the business being taken over. Myanmar's foreign trade, for example, is completely nationalised. Generally this action affects the whole industry rather than just a single company. Mexico attempted to control its debt problem. President Jose Lopez Portillo nationalised the country's banking system. In another case of nationalisation, Libya's Col. Gaddafi's vision of Islamic socialism led him to nationalise all private business in 1981. India nationalised its banking, transportation and insurance industries in 70s.

In domestication, foreign companies relinquish control and ownership either completely or partially to the nationals. The result is that private entities are allowed to operate the confiscated or expropriated properties. The French government, after finding out that the state was not sufficiently proficient to run the banking business, developed a plan to sell 36 French banks.

Domestication may sometimes be a voluntary act that takes place in the absence of confiscation or nationalisation. Usually, the causes of this action are either poor economic performance or

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social pressures. When situations worsened in South Africa and political pressures mounted at home, Pepsi sold its South African bottling operations to local people and Coca-Cola signaled that it would give control to a local company.

General instability risk is related to the uncertainty about the future viability of a host country's political system. The Iranian revolution that overthrew Shah of Iran is an example of this kind of risk. In contrast, ownership/controlled risk is related to the possibility that the host government might take action (expropriation) to restrict an investor's ownership and control of a subsidiary in that host country.

Operation risk proceeds from the uncertainty that a host government might constrain the investor's business operations in all areas including production, marketing and finance. Finally, transfer risk applies to any future acts by a host government that might constrain the ability of a subsidiary to transfer payments, capital, or profits out of the host country back to the parent firm.

The 70s were the peak period for expropriation activities. The number of expropriation acts peaked at 83 involving 28 countries in 1975 representing 14.4% of all such acts (574) which took place between 1960 and 1992. Based on 1980 and 1992 data, expropriation is unlikely in future.

Indicators of Political Instability

In order to assess a potential marketing environment, a company should identify and evaluate the relevant indicators of political difficulty. The sources of political instability include social unrest, the attitude of nationals and the policies of the host government.

Social unrest is a social disorder that is caused by such underlying conditions as economic hardship, internal dissension and insurgency and ideological, religious, racial and cultural differences. Lebanon has experienced conflict among Christians, Muslims and other religious groups. The Hindu-Christian conflict in India is another example of social unrest. Though a company may not be directly involved in the local disputes, yet its business can still be severally disrupted by such conflicts.

Human nature involves monostary (the urge to stand alone) as well as systems (the urge to stand together) and the two concepts provide alternative ways of utilising resources to meet a society's needs. Monostary encourages competition but systems emphasize cooperation. As explained by Alderson, "*A co-operative society tends to be a closed society. Closure is essential if the group is in some sense to act as one*". China, although wanting to modernise its economy, does not fully embrace an open economy, which is likely to encourage dissension among various groups. For the sake of its own survival, a cooperative society may have to obstruct the dissemination of new ideas and neutralise an external group that poses a threat. China apparently has learnt a lesson from the Soviet Union's experience.

A liberated political climate can easily lead to a call of the long suppressed national minority group for cultural and territorial independence. The group's conflicts, unsettled but subdued during the communist period, are likely to escalate. Three kinds of conflicts may occur. First, a domestic dispute may escalate into violence that is confined within the boundaries of the country in question. The civil war that started in 1991 between Serbs and Croats in Yugoslavia is a classic example of this.

Another example is the centuries old ethnic animosity between Christian Armenia and Muslims neighbouring Azerbaijan, which led some 600 Armenian nationalists to clash with Soviet soldiers during earth quake rescue operations in Armenia. Second, an internal dispute may draw interested parties outside the country in question into the conflict.

Example: Problems in Yugoslavian Macedonia may force Bulgaria and Greece to intervene. Finally, the third form of conflict resulting either from first two kinds of conflicts or

from international dispute may lead to a direct confrontation between the two countries. Romania and Hungary, who have deep-rooted grievances against each other, could become involved in this form of conflict. India and Pakistan are also deeply involved in this form of conflict though the main cause is the Kashmir problem.

Attitudes of Nationals

An assessment of the political climate is not complete without an investigation of the attitudes of the citizens and government of the host country. The nationals' attitude towards foreign enterprises and citizens can be inhospitable. Nationals are often concerned with foreigners' intentions with regard to exploitation and colonialism, and these concerns are often linked to concerns over foreign governments' actions that may be seen as improper. Such attitudes may arise out of local socialist or nationalist philosophies, which may be in conflict with policy of the company' home country government. The governments may come and go, but citizens' hostility may remain. For example, 12 US firms decided to leave El Salvador in 1980s.

Policies of the Host Government

Unlike citizens' inherent hostility, the government's attitude towards foreigners is often relatively short-lived. The mood can change either with time or change in leadership and it can change for either the better or the worse. The impact of change in mood can be quite dramatic especially in the short run.

Government policy formulation can affect business operations either internally or externally. The effect is internal when the policy regulates the firm's operations within the home country. The effect is external when the policy regulates the firm's activities in another country.

Example: An internal policy is Quebec's Bill 101. The Bill requires all business to be conducted entirely in French and dictates where the investments of insurance and trust companies will be placed. When this Bill was passed, the reaction was a massive capital flight of some $ 57 billion. One major investment company alone moved in $90.2 billion portfolio from Montreal to Ottawa.

Although an external government policy is irrelevant to firms' doing business only in one country, such a policy can create complex problems for firms doing business in countries that are in conflict with each other. A company in one country, for example, may be prohibited from doing business with other countries that are viewed as hostile. A dispute over the boundary between Chile and Argentina prompted Argentina to restrict traditional exports to Chile including petrochemicals, pharmaceuticals, vehicles and vehicle parts. The restriction disrupted the marketing plans of General Motors, Peugeot and Renault all of which supplied Chile with automobile parts from Argentina plants. Similarly, India and Pakistan have restricted their export-import because of the long outstanding Kashmir boundary dispute between the two countries.

The use of unfriendly rhetoric before an election may be nothing but a smoke screen and the 'bark' will not necessarily be followed by a 'bite'. Companies need not take drastic action if they are able to endure through the election. Ronald Reagan, an advocate of free trade, became much more of a protectionist just before his election in 1984. After the election, a policy of free trade was reinstituted.

The experience of Enron Corporation with the $ 2.8 billion Dhabol project in India is an example of this nature. In 1992, Enron and Prime Minister Narsimha Rao's reformist government quickly signed memoranda of understanding to build the massive power complex in Maharashtra. Having no domestic partner, the deal's secrecy coupled with company's efforts to keep the details confidential, the lack of competitive bidding, government loans guarantee and a high rate of return (23%) all contributed to a negative public perception. The company failed to seriously

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consider the sentiment of an opposition coalition led by the Bhartiya Janta Party. The party's 1995 campaign for state election called for a re-evaluation of the 2015 MW Dhabol Project. Enron responded by quickly beginning the construction believing that it would become more difficult for a new government to reverse the process. Enron's request that the US Energy Department intervene only invited even more backlash. In the end the project was suspended before being negotiated.

Self Assessment

Choose the appropriate answers:

1. When considering entry into a foreign country, any multinational marketer would be well advised to make a through analysis of .....
   (a) Social risk
   (b) Natural risk
   (c) Political risk
   (d) None of these
2. Any review of a country's political system and its impact on foreign business must remain free of ..... notions.
   (a) stereotyped
   (b) branding
   (c) trading
   (d) none of these
3. The sources of political instability include .....
   (a) social unrest
   (b) attitude of nationals
   (c) policies of the host government
   (d) all of the above

5.2 Economic Environment

The international marketer is fortunate in having a substantial body of data available that charts the nature of the environment on a country-by-country basis. Each country has national accounts data, indicating estimates of gross national product, gross domestic product, consumption, investment, government expenditures and price levels. Also available on a global basis are demographic data indicating the number of people, their distribution by age category, and rates of population growth. National accounts and demographic data do not exhaust the types of economic data available. A single source, *The Statistical Year book of the United Nations*, contains global data on agriculture, mining, manufacturing, construction, energy production and consumption, internal and external trade, rail, road and air transport, wages and prices, health, housing, education, communication (mail, telegraph and telephone), and mass communications by book, film, radio, and television. These data are available for all high income countries. The less developed a country is, the scarcer is the availability of economic data. In the low income countries of the world, one cannot be certain of obtaining anything more than basic national accounts and demographic and external trade data. Nevertheless, in considering the world's economic environment, the marketer's problem is not one of an absence of data but rather one of

abundance. This unit will identify the most salient characteristics of the economic environment to provide the framework for further consideration of the elements of an international marketing programme.

5.2.1 The World Economy — An Overview

The world economy has changed profoundly since World War II. Perhaps the most fundamental change is the emergence of international markets; responding to new opportunities, international competitors have steadily displaced local ones. Concurrently, the integration of the world economy has increased significantly. Economic integration stood at 10 per cent at the beginning of the 20th century, today it is approximately 50 per cent. Integration is particularly striking in two regions, the European Union (formerly the European community) and the North American Free Trade Area.

5.2.2 Marketing and Economic Development

An important concern in marketing is whether it has any relevance to the proof of economic development. Some people believe the field of marketing is relevant only to the conditions that apply in affluent, industrialized countries where the major problem is one of directing society's resources into ever-changing output or production to satisfy a dynamic market-place. In the less developed countries, the argument goes; the major problem is the allocation of scarce resources toward obvious production needs. Efforts should focus on production and how to increase output, not on customer needs and wants.

Conversely, it can be argued that the marketing process of focusing an organization's resources on environmental opportunities is a process of universal relevance. The role of marketing – to identify people's needs and wants and to focus individual and organizational efforts to respond to these needs and wants – is the same in both low and high income countries. For example, pursuing alternative sources of energy such as wind and solar power is important for two reasons: the lack of coal reserves in many countries, and concerns that over reliance on fossil fuels will contribute to global warming. These concerns have led to the development of solar-powered lanterns that are used in villages in India. Similarly, solar water heaters have been installed in Gaborone, the capital of Botswana, eliminating as much as 40 per cent of the energy requirements for thousands of families.

5.2.3 Economic System

There are three types of economic systems: capitalist, socialist and mixed. This classification is based on the dominant method of resource allocation: market allocation, command or central plan allocation, and mixed allocation, respectively.

A recent report by Washington DC – based on Heritage Foundation — ranked more than 100 countries by degree of economic freedom. Ten key economic variables were considered: trade policy, taxation policy, government consumption of economic output, monetary policy, capital flows and foreign investment, banking policy, wage and price controls, property rights, regulations and the black market. The rankings form a continuum form "free" to "repress" with "mostly free" and "mostly unfree" in between. Hong Kong is ranked number 1 in terms of economic freedom; Cuba and North Korea are ranked lowest.

5.2.4 Stages of Market Development

International country markets are at different stages of development. GNP per capita provides a very useful way of grouping these countries. Using GNP as a base, we have divided international markets into four categories. Although the income definition for each of the stages is arbitrary,

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countries in each of the four categories have similar characteristics. Thus, the stages provide a useful basis for international market segmentation and target marketing.

5.2.5 Location of Population

We have already noted the concentration of 74 per cent of world income in the triad (North America, the EU, and Japan). In 1997, the 10 most populous countries in the world accounted for 52.5 per cent of world income, and the 5 largest accounted for 48.3 per cent. The concentration of income in the high income and large-population countries means that a company can be global — derive a significant proportion of its income from countries at different states of development — while operating in 10 or fewer countries.

For products whose price is low enough, population is a more important variable than income in determining market potential. Although population is not as concentrated as income, there is, in terms of size of nations, a pattern of considerable concentration. The 10 most populous countries in the world account for roughly 60 per cent of the world's population today.

The economic role of government can best be defined by a classification of its economic policy aims. Broadly speaking the political choices made by electorates in Western-type democracies influence governments perform four functions.

The first is production of services which private firms are either unwilling to produce or for some reason are not allowed to produce (or at least not exclusively). This public provision may be to provide immediate benefits (e.g. defence, law and order) or deferred benefits (e.g. investment in roads).

These 'production' activities may be divided into two types:

1. Services which are not sold in the market but are financed out of compulsory levies. It is considered preferable in economic analysis to treat the government here as a collective consumer in a position to influence the allocation of resources, rather than as a producer because the 'output' is intangible and is not priced. For our purposes, what is important is that the government has to purchase in the market the current output of private firms and the labour services of households in order to fulfil its task. It can, of course, 'rig' the market.

Example: The UK government is not only an important purchaser of vehicles for use in government departments; it also buys almost exclusively only vehicles produced in the India.

2. Goods produced and sold in the market by public corporations. Many countries have state-owned fuel and power industries whose operation is very similar to private industry though the policy instructions laid down by governments for their operation will usually include objectives other than the making of profits.

The second function is the alteration of the structure of private production in order to conform to some conception of the allocation of resources which is considered 'better' than that resulting from private market transactions. This aim has already been illustrated in the example given in. In the national accounts, this aim will be reflected in the choice of taxes levied on goods and services (e.g. taxes on expenditure), in corporation taxes and in current subsidies.

The third function is to intervene in the distribution of income generated by private market transactions in order to conform to some acceptable criterion of equity, for example a minimum income guarantee. This will be reflected in the national accounts principally in the choice of taxes and in the provision of transfer payments to households against which there is no counter flow of current services. For example, state pension payments are transfer payments, and though pensioners do not render current services in order to receive them, they may have contributed to their finance through compulsory levies on their past incomes. Transfer payments do not form

Notes

a direct link between government and industry but major efforts by government to alter income distribution have considerable influence on the structure of household purchases and therefore on the pattern of demand for industrial products.

The fourth function is the stabilization of the economy by attempting to reduce fluctuations in income and employment and to control movements in the general price level. The effects of this action can be seen in both the volume and the mix of transactions between the government and the rest of the economy. Policy models of the economy which place particular emphasis on the control of the money supply and interest rates will pay close attention to the size of the government budget deficit/surplus. Therefore, no particular transaction with the private sector is solely identified with this function except perhaps for the interest paid by government to firms and households as a payment for holding government debt accumulated in the course of financing past government deficits.

Self Assessment

Fill in the blanks:

4. ..... country markets are at different stages of development.
5. ..... per capita provides a very useful way of grouping these countries.
6. There are ..... types of economic systems: capitalist, socialist and mixed.
7. The world economy has changed profoundly since ..... .
8. The international marketer is fortunate in having a substantial body of data available that charts the nature of the environment on a ..... basis.

Task Discuss factors hindering Indian economy and its growth.

5.2.6 Budget

Every year democratic countries present, for the approval of their parliaments, a budget alongside which there will be published extensive information on the central government's finances, including accounts of past years. In this respect governments have to achieve certain standards of accountability and audit. It is taken for granted here that these standards are being met and this enables us to concentrate on the method of presentation of accounting data by the government which gives us the best idea of its structure and size in relation to the rest of the economy. While accounting and audit standards will require the government to produce full information on the responsibility of each main administrative unit for its use of authorized funds, what is needed here is an economic classification which enables us to identify government transactions which have their counterpart in receipts and payments of other major sectors of the economy presents such a classification is a typical extract from data supplied by governments when they are putting forward the annual budget. When considering the government's place in the economy and its impact on business, the following check-list of questions should be applied.

Notes

Self Assessment

Fill in the blanks:

9. ..... and ..... standards require the government to produce full information on the responsibility of main administrative unit for use of authorized funds.

10. The Ministry of Finance may have an important role to play in influencing the finance of industry with the ..... .

Caselet

Acer's US Foray runs into Trouble

Acer, the Taiwanese computer maker illustrates the challenges faced by companies based in emerging markets while entering developed markets. After developing a strong presence in south east Asia and Latin America, Acer decided to target the US market with its popular Aspire Home PC. Acer soon found itself being outmaneuvered by stronger rivals such as Dell with superior marketing capabilities. As the Aspire line began to pile up losses, Acer announced that it would concentrate on its Power PCs, backed by a $10 million marketing campaign to target small and medium businesses. Acer also indicated that it might launch low cost computer appliances called XCs priced $200 or lower once they were established in Asia. But Acer's market share slipped from 5.4% (late 1995) to 3.2% (late 1998) and it began to make losses in the US market.

Part of the problems arose because customers for Acer's contract manufacturing arm worried about spill over of business secrets to and cross subsidization of Acer's offerings under its own brand name. In 2000, IBM cancelled a major order, reducing its share of contract manufacturing in Acer's revenues from 53% in the first quarter of 2000 to only 26% in the second quarter of 2001.

Founder Stan Shih had once told his executives that a strong presence in America was vital to the development of a global brand: "It's almost a mission impossible but all of our people are ready to fight for that mission." These hopes however were belied and after losing $45 million in the US, in 1999, Acer began to retreat from the US consumer market.

Acer decided to target developed countries with contract manufacturing and offer its own brands in the Asian region. The contract manufacturing activities were spun off into a separate arm called Wistron. Recently, Acer has made a bold move by announcing it will buy leading PC maker, Gateway for $710 million. This will not only significantly, strengthen Acer's presence in the US, taking its market share from about 5.2% to 10.8% but also make it the world's third largest PC maker ahead of China's Lenovo. After the acquisition is completed, Acer will generate sales of more than $15 billion and ship over 20 million PCs every year. But Acer will continue to trail well behind the market leaders in the US, Dell (28.4%) and Hewlett Packard (23.6%).

Source: www.vedpuriswar.org/.../Going**Global**/Chapter%2006_...

5.3 Need for Government Intervention in Business

Government regulation at the central and state levels has a major impact on how businesses operate in the India. In order to manage business activities in a complex society and to help respond to changing societal needs, governments at all levels have created numerous regulatory agencies. Although the duties and functions of each agency vary, all influence the day-to-day business activities that take place within the India. Businesses that take a proactive stance toward

understanding and complying with central regulatory agencies will minimize their chance of fines, prosecution, or other regulatory action. Therefore, it is in the best interest of businesses to maintain healthy relationships with regulatory agencies at all levels of government. Among the business activities regulated by government are competitive practices, industry-specific activities, general issues of concern, and monetary regulations.

5.3.1 Central Communications Commission (CCC)

The CCC monitors and regulates CB radio, radio, telegraph, telephone, and television operations. It has broad powers to set acceptable standards for television regarding language, nudity, violence, or other material that may be perceived as inappropriate by the general public. For example, television shows that are adult-oriented or contain violence are typically on late in the evening so that children are less likely to see them. In addition, television shows often warn viewers about their content through a rating system; since the rating is displayed on the screen, viewers can make an informed decision before watching a particular program.

The CCC also has the power to fine broadcast companies that use inappropriate language in their programming. Since most television and radio stations know what are considered acceptable standards, fines are rarely issued. When fines are issued, however, a television or radio station may take the FTC to Supreme Court to appeal the decision. Broadcast companies that fight the CCC over a show's content normally argue that the First Amendment gives them the right to broadcast the contested material.

5.3.2 Food and Drug Administration (FDA)

The FDA is responsible for ensuring the safety of cosmetics, drugs, and food. One of the most important functions of the agency is new drug approval. The FDA requires pharmaceutical companies to provide detailed scientific data regarding new drugs prior to approval. Specifically, the FDA will review the potential benefits and negative side effects of all proposed drugs. The agency reviews the information submitted by the pharmaceutical company and may also conduct its own tests if additional study is deemed needed. The FDA is extremely important to the business community because if it rejects a new drug, the pharmaceutical company developing it cannot sell it. FDA regulators must balance the interests of the general public with those of the pharmaceutical company. The FDA does not endorse new drugs; rather, it approves them, stating that they are thought to be safe.

5.3.3 Equal Employment Opportunity Commission (EEOC)

The Civil Rights Act of 1964 prohibits discrimination on the basis of race, colour, creed, sex, or national origin. This law applies to almost every private company, non-profit organization, and government employer, although some exceptions were granted to religious corporations, Indian tribes, and private-membership clubs. The Civil Rights Act also created the Equal Employment Opportunity Commission.

5.3.4 Occupational Safety and Health Administration (OSHA)

Enacted in 1970, the Occupational Safety and Health Administration, was designed to ensure safe and healthy working conditions in nearly every environment. OSHA's basic premise is that employers must provide a work environment that is safe and free from hazards that may cause harm or death to their employees. In addition, employers are obligated to follow occupational safety and health standards that are ordered by the secretary of labor (OSHA falls under this department). Employers are given written guidelines so they know specific OSHA rules and regulations.

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Did u know? In 1970, OSHA was established for ensuring safe and healthy working conditions.

In order to verify that organizations are complying with these regulations, OSHA can conduct surprise inspections. Technically, employers can ask OSHA to show a search warrant before the search is executed, but this is not normally done because OSHA can get a warrant relatively quickly. OSHA investigators may inspect the building, but an employer has the right to have a representative accompany the regulators during the tour. The investigators review accident records and other documents to verify that compliance has been maintained. OSHA investigators also observe employees to verify that guidelines set by the agency are followed (e.g., wearing eye protection). If OSHA investigators believe that violations have occurred, they can issue citations against the employer. If the employer agrees to pay a fine, OSHA will normally inspect the building at a later date to ensure compliance. If an employer believes that the fine or other sanction is inappropriate, a court order can be sought seeking relief from the fine or sanction. In rare instances, the secretary of labor may ask for an injunction against an employer. Injunctions are only sought in the most serious cases, such as those in which there is imminent danger to employees.

Caution Verification of the non-compliance of OSHA regulations is conducted through surprise inspections.

5.3.5 Environmental Protection Agency (EPA)

One of the most pressing issues in the India is protecting the environment. A combination of pressure from consumer groups, news media, and voters encouraged Government to pass legislation creating the Environmental Protection Agency in 1972. Prior to the creation of the EPA, no single Central agency had control over environmental issues, resulting in fragmented enforcement and confusing or conflicting codes. The EPA was created to act as the focal point regarding all pollution issues (air, noise, water, etc.).

Notes One of the most pressing issues in the India is protecting the environment.

Self Assessment

Fill in the blanks:

11. Dictatorship is also called as ..... .
12. NAFTA Stands for ..... .
13. SEBI stands for ..... .
14. The ..... is responsible for ensuring the safety of cosmetics, drugs, and food. One of the most important functions of the agency is new drug approval.
15. Enacted in 1970, the ....., was designed to ensure safe and healthy working conditions in nearly every environment.
16. The ..... was created to act as the focal point regarding all pollution issues (air, noise, water, etc.).

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5.3.6 Consumer Product Safety Commission (CPSC)

Another powerful central agency was created in 1972 under the Consumer Product Safety Act. The law created the Consumer Product Safety Commission, which was intended to protect consumers from defective and dangerous products. In addition, Government wanted to unify the majority of laws regarding product safety (except food, automobiles, and other products already regulated by federal agencies) so that they would be effective and clear. The CPSC is very powerful; it can ban products without a court hearing if they are deemed dangerous and can order recalls, product redesigns, and the inspection of production plants. In more severe cases, the CPSC may also charge officers, managers, and/or supervisors with criminal offenses.

Notes Another powerful central agency was created in 1972 under the Consumer Product Safety Act. The law created the Consumer Product Safety Commission, which was intended to protect consumers from defective and dangerous products.

5.3.7 Central Monetary Regulatory Agencies

Several federal agencies have been established to monitor monetary practices in the India, including the Securities and Exchange Commission, the Central Reserve Board, and the Central Deposit Insurance Corporation.

Securities and Exchange Commission (SEC)

The SEC was established to regulate the securities industries in the India. A quasi-regulatory and judicial agency, the SEC regulates publicly traded stock-offering companies by requiring them to issue annual and other financial reports. In addition, the SEC regulates the stock market, brokers who sell securities, and large investment firms. The SEC also looks for insider trading, such as trading on secret knowledge about a company, other white-collar crime that may affect a company's stock price, and securities fraud by stockbrokers. The agency can initiate civil or criminal action against the individual or firms charged with securities violations. Depending on the circumstances, the penalties levied by the SEC can be severe, with large fines and long jail terms being the norm. The SEC normally works closely with the Justice Department when criminal prosecution is involved. As always, the SEC's actions can be appealed to the federal courts if the individual or firm believes the charges are inaccurate or unjust.

Central Reserve Board

As the India grew, the nation's banking system became more complex and subject to greater fluctuations without government regulation. The India experienced an acute money panic in 1907 that put a severe strain on the banking system. As a result of the financial panic, a National Monetary Commission was established by Government to study how the India could protect the banking system and, in turn, the money supply. National Monetary Commission recommendations were implemented by Government in 1913 when the Central Reserve Act was passed and the Central Reserve Board was established. The primary purpose of the Central Reserve Board is to function as a semi-independent board designed to protect the banking system in the India.

Did u know? SEC was founded in 1992 to regulate securities industries in India.

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Case Study **Bata Ltd.**

In 1996, Bata Ltd. was struggling to determine its future, both in defining its long-term strategy and in finding a top management team who would move the company into the 21st century. In doing so, it was deeply affected by the dramatic political changes taking place in Eastern Europe, South Africa and elsewhere.

As war swept across Europe in 1939, Tom Bata, Sr., was faced with a difficult situation. His father, the ninth generation of a family of Czechoslovakian shoemakers, had built a worldwide shoe network in 28 countries, using machinery and mass production technology of the 1920s.

On his father's death, Tom Bata, Sr., was left with the responsibility of expanding that empire during a period of great political uncertainty, worldwide. Because of the Nazi invasion of Czechoslovakia and the uncertain future endangered by the resulting occupation, Tom Bata, Sr., sought to preserve his father's business by abandoning his Czechoslovakian operations and immigrating to Canada with a hundred of his managers and their families. His Czech operations were subsequently taken over by the communists after World War II.

Since that time, Bata's decision has been ratified through strong growth, worldwide.

The company is a family-owned business that is the world's largest manufacturer and retailer of footwear. Activities are carried out in over 60 countries, employing more than 67,000 people worldwide. Bata operates 6,300 company-owned stores worldwide and has over 100,000 independent retailers and franchisees over 70 manufacturing units worldwide, including shoe manufacturing plants, engineering plants producing moulds, quality control laboratories, hosiery factories and tanneries. Bata produces about 170 million pairs of shoes annually and sells about 270 million pairs worldwide (see Bata's website for current information).

It might appear that Bata is a multi-domestic company where local managers are free to adjust operating procedures to local environments, within certain parameters. However, Bata's core philosophies and strategies are tightly controlled by Bata himself, who was 82 in 1996. In 1994, Bata hired the company's first non-family chief executive in an attempt to reinvigorate the paternalistic company, but disagreements over the future of the company forced the resignation of the CEO and two of the top members of his management team in October 1995.

The problem is that the shoe business is changing and Bata is being affected like any other company. The key to Bata's success has traditionally been a low-cost manufacturing base, tied to an extensive distribution network. But Nike and Reebok turned the footwear industry into one that was market-driven, not manufacturing-driven. Several of Bata's retail outlets began losing money and Bata was forced to close down 20 percent of its retail outlets in 1995 and 1996.

Although Bata has factories and operations of various forms in many countries, it does not own all of those facilities. Where possible, it owns 100 percent of them. The governments of some countries, however, require less-than-majority ownership. In some cases, Bata provides licensing, consulting and technical assistance to companies in which it has no equity interest.

The company's strategy for serving world markets is instructive. Some MNEs try to lower costs by achieving economies of scale in production, which means they produce as much as possible in the most optimally-sized factory and then serve markets worldwide from that

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single production facility. Bata serves its different national markets by producing in a given market, nearly everything it sells in that market. It does this in part because substantial sales volume in the countries in which it produces, enable it to achieve economies of scale very quickly. It may seem difficult to believe that Bata can always achieve economies of scale, especially since the company has production facilities in some small African nations. However, Bata's management believes that the company can achieve scale economies very easily because its shoe production is a labour-intensive operation. It also tries to buy all its raw materials locally, although this is not always possible, especially in some poorer countries.

Bata also prefers not to export production. When possible, it chooses local production to serve the local market rather than imports. However, sometimes Bata becomes entangled with local governments when it imports some raw materials but does not export. In such cases, it must adjust to local laws and requirements for operation. Bata avoids excessive reliance on exports partly to reduce its risks. For example, if an importing country were to restrict trade, Bata could possibly lose market opportunity and market share.

Bata operates in many different types of economies. It has extensive operations in both industrial democratic countries and developing countries. However, it was soundly criticized for operating in South Africa and thus tacitly supporting the white minority political regime. It also has been censured for operating in totalitarian regimes, such as that in Chile. In the latter case, *Tom Bata, Sr., countered by pointing out that the company had been operating in Chile for over forty years, during which time various political regimes were in power.*

Despite Bata's ability to operate in any type of political environment, *Tom Bata Sr., prefers a democratic system. He feels that both democratic and totalitarian regimes are bureaucratic, but a democracy offers the potential to discuss and change procedures, whereas under totalitarianism, it sometimes is wisest to remain silent.* Bata has a multifaceted impact on a country. Its product is a necessity, not a luxury. The company's basic strategy is to provide footwear at affordable prices for the largest possible segment of the population. The production of shoes is labour-intensive, so jobs are created, which increases consumers' purchasing power. Although the top management may come from outside the country, local management is trained to assume responsibility as quickly as possible. Because the company tries to get most of its raw materials locally, sources of supplies usually are developed. Further, it likes to diversify its purchases, so it usually uses more than one supplier for a given product, which leads to competition and efficiency.

South Africa presented unique challenges for Bata management. The size of the country's population is just under that of Nigeria, Egypt or Ethiopia. Thus, South Africa had long been considered a good place in which to invest because of its large market size. Further, South Africa's per capita GNP was the largest in Africa. However, the country's main attraction was the incredibly high rate of return that companies could earn, which was largely the result of low-labour costs and extensive mineral wealth. The large market allowed companies to achieve economies of scale in production while exploiting low labour costs.

But the situation deteriorated rapidly in the early 1980s. A relatively stagnant economy, political strife resulting from apartheid, including the policy of not granting political freedom and civil liberties to blacks, prompted foreign companies and governments to pressurize the government for political reforms. The Canadian attitude towards South Africa was very negative. Canada's government issued very conservative voluntary guidelines on new investments in South Africa. As a result, Bata sold its holdings in South Africa in 1986. It did not identify the buyer or the sales price and it denied that apartheid was the reason for its pulling out. Company personnel stated, *"It really was a business decision that took into account all of the factors with respect to investment in South Africa at the present time."* Under the terms of the sale the Bata company name and trademark could no

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longer be used in South Africa and all ties with Canadian headquarters were broken. In addition, the new buyer apparently assured that the jobs of the workers, most of whom are black, would be preserved.

Bata also faced problems trying to get back into Slovakia. As noted earlier, the Bata operations started in former Czechoslovakia and as Eastern Europe opened up, Bata immediately tried to recover lost investments in the Czech Republic and Slovakia. The problem was that the Czech and Slovak governments wanted compensation for the factories, but Bata (known as Tomas Baoa in his homeland) felt that the factories were still his. He eventually opened one factory in the Czech Republic and 48 retail outlets where the company sold 3 million pairs of shoes in the first year, capturing 11 percent of the Czech shoe market.

However, things were not so rosy in Slovakia. Tom Bata said that the problem is that *"his company's former Slovak properties ended up in the hands of the Slovak government, which is not interested in giving them up. Instead, he is expected to rebuild his Slovak business using his own resources."* He says that he is still waiting for the government to keep the promise it made when his 45,000 employee factory in Slovakia was nationalized. Compensation was promised by the communists but never paid. The official government position is that a new restitution law has been put into effect and that Bata has to raise his ownership claims with the new owner of the factory. If the two parties cannot agree to a joint solution to the problem, Bata is welcome to file a lawsuit against the new owner to be settled in Slovakian courts. Despite his success in the Czech Republic, Bata had not sold one pair of shoes in Slovakia by the beginning of 1996.

Questions

1. Evaluate the different ways in which Bata has interacted with foreign political systems in its investments and operations abroad.
2. Do you think Bata made the correct decision to pull out of South Africa? How do you think the political events in South Africa in the past few years might change Bata's strategy for South Africa? How should Bata formulate a strategy for determining whether or not to re-enter South Africa?
3. What are the advantages and disadvantages to both Bata and the Republic of Slovakia of having Bata take over his former operations? Why do you think the Czech Republic allowed Bata to re-enter the market, but Slovakia had not, at the end of 1995?
4. Why do you think Tom Bata, Sr., has joined the list of entrepreneurs who cannot bear to loosen their grip on businesses they started? What is the risk to Bata, Ltd. if Tom Bata, Sr. cannot find a way to retire?
5. What are the reasons which forced Bata to close down 20 percent of its retail outlets in 1995 and 1996?
6. What was the policy of Bata towards export production?

Source: John D. Daniels and Lee H. Radebaugh, *International Business Environments and Operations,* 8th ed., 1992, Pearson Education Asia, p.130.

5.4 Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- Government regulations and agencies at all levels of government have had a major impact on how businesses operate.
- In order to manage business activities in a complex, ever-changing society, governments at all levels have created numerous regulatory agencies through the legislative process.

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- Although the duties and function of agencies vary, all influence day-to-day business practices.
- Frequently regulated business activities include competitive practices, industry specific activities, general issues of concern, and monetary regulations.

5.5 Keywords

Confiscation: It means seizing of company's assets without payment.

Democracy: It is for the people, by the people, and of the people, its similar to participative management, in this system people are encouraged to participate in decision making, a peoples representative can be selected by the people through a process of election, and the responsibility of leading the nation is kept on the shoulders of the elected representative. e.g, India.

Dictatorship: It is also called as authoritarianism, which is quite opposite to democracy, here the hole power is in the hands of the leader, and people should follow the leader, all the policies related to economy, business etc are governed by the leader. e.g, Saudi Arabia.

Domestication: It occurs when host country takes steps to transfer foreign investments to national control and ownership through series of government decrees.

Expropriation: It requires reimbursement, for the government seized investment.

General Instability Risk: It is related to the uncertainty about the future viability of a host country's political system.

Operation Risk: It proceeds from the uncertainty that a host government might constrain the investor's business operations in all areas including production, marketing and finance.

5.6 Review Questions

1. Discuss the political environment. What are its features?
2. What are the different types of political systems?
3. What is the need for government intervention in business?
4. What do you mean by sovereignty of nations?
5. Enumerate the political risks of global business.
6. Discuss the different types of political parties.
7. What are the factors affecting global business?
8. Give an overview of the world economy.
9. What are the various stages of market development?
10. Write short notes on:
    (a) Central Communications Commission (CCC)
    (b) Food and Drug Administration (FDA)

Answers: Self Assessment

1.	(c)	2.	(a)
3.	(d)	4.	International
5.	GNP	6.	three

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7. World War II
8. country by country
9. Accounting, audit
10. Ceutral Bank
11. Authoritarianism
12. North American Free Trade Agreement
13. Securities Exchange Boards of India
14. FDA
15. Occupational Safety and Health Administration
16. EPA

5.7 Further Readings

Books

C.B. Gupta, *Business Environment.*

Francis Cherunillam, *Global Business Environment.*

M. Kapagam, *Environmental Economics.*

Philip R. Cateora, *International Marketing.*

Online links

clt.astate.edu/gguha/Courses/IMktg/chap02pp.ppt

www.economics.gov.nl.ca/E2012/GlobalEconomicEnvironment.pdf

Unit 6: Modes of Entering International Business

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Objectives

After studying this unit, you should be able to:

- Explain how firms choose which foreign markets to enter and at the factors that are important in determining the best timing and scale of entry
- Discuss the choice of entry mode
- Describe the role of strategic alliances

Introduction

The choice for entering foreign market is another major issue with which international business 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 firms, setting up a new wholly owned subsidiary in host country to serve its market, or acquiring an established enterprise in the host nation to serve the market. The optimal entry mode varies by situation depending on factors like transport costs, trade barriers, political risks, economic risks, and firm strategy.

6.1 Modes of Foreign Expansion

In this unit, we discuss three basic decisions that a firm contemplate while making foreign expansion

(a) Which markets to enter?

(b) When to enter those markets, and

(c) On what scale.

Which Foreign Markets?

There are number of nation-states in the world and all of then do not hold the same profit potential for a firm entering foreign market. The choice must be based on an assessment of a nation's long run profit potential. This potential is a function of several factors such as:

1. Detail of the economic and political factors that effect the potential attractiveness of a foreign market.

2. Balancing of benefits, costs, and risks associated with doing business in that country.

   With regard to political factors the cost of doing business in a country can be increased by a need to pay off the politically powerful to be allowed by the Government to do business. 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 raises costs.

   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 work place, environmental pollution, and the like. It can be more costly to do business in a country that lacks well-established laws for regulating business practice. 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.

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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 particular business enterprise. Political risks tend to be greater in countries experiencing social unrest and disorder or in countries where the underlying nature of the society increases the likelihood of social unrest. Social unrest typically finds expression in strikes, demonstrations, terrorism and violent conflict.

Economic risks can be defined as the likelihood that 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. One visible indicator of economic mismanagement may be the country's inflation rate, another may be the level of business and government debt in the country. Economic risks are not independent of political risk. Economic mismanagement may give rise to social unrest and hence political risk.

The legal risks may 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.

The overall attractiveness of a country as a potential market and/or investment site for an international business depends on balancing the benefits, costs and risks associated with doing business in that country. Generally the costs and risks associated with doing business in foreign country are typically lower in economically advanced and politically stable democratic nations and greater in less developed and politically unstable nations.

3. Study 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. 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 relatively small market when measured in economic terms. Further the costs and risks associated with doing business in a foreign country are typically lower in economically advanced and politically unstable nations.

4. Potential long-run benefits bear little relationship to a nation's current stage of economic development or political stability. Long-range benefits depend on likely future economic growth rates, and 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).

5. By following the above process a firm can rank countries in term of their attractiveness and long run profit potential. Preference is then given to entering markets that rank highly. In the case of ING, their latest international venture in the financial services business has been focused in Europe and North America. These regions have large financial services markets and exhibit relatively low political and economic risks, so it makes sense that they would be attractive to ING. The company should be able to capture a large enough share of the market in each country to justify its investment in setting up business there.

Timing of Entry

Once attractive markets have been identified, it is important to consider the timing of entry. The advantages frequently associated with entering a market early are commonly known as first-mover advantages. One first mover advantage is the ability to preempt rivals and capture demand by establishing a strong brand name. 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.

Notes

There can be disadvantages associated with entering a foreign market which are often referred to a first-mover disadvantages. These disadvantages may give rise to pioneering 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 an enterprise has to devote considerable effort, time, and expense to learning the rules of the game, e.g, costs of business failure due to ignorance of the foreign environment, certain liability associated with being a foreigner, the costs of promoting and establishing a product offering including the costs of educating customers, change in regulations in a way that diminishes the value of an early entrant's investments.

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. For example, ING had to spend several billion dollars to acquire its US operations. Not all firms have the resources necessary to enter on a large scale, and even some firms prefer to enter foreign markets on a small scale and then build slowly as they become more familiar with the market.

6.2 Modes 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.

6.2.1 Exporting

Using domestic plant as a production base for exporting goods to foreign markets is an excellent initial strategy for pursuing international sales. Exporting is the marketing and direct sale of domestically-produced goods in another country. Exporting is a traditional and well established method of reaching foreign markets. Since exporting does not require that the goods to be produced in the target country, no investment in foreign production facilities is required. Most of the costs associated with exporting take the form of marketing expenses.

Exporting commonly requires coordination among four players:

1. Exporter,
2. Importer,
3. Transport provider, and
4. Government.

Advantages of Exporting

Some of them are discussed as under:

1. It minimizes both risk and capital requirements and it is conservative way to test the international waters. With an export strategy the manufacturer can limit its involvement in foreign markets by contracting with foreign wholesalers experienced in importing to handle the entire distribution and marketing function in their countries or regions of the world. If it is more advantageous to maintain control over these functions, a manufacturer can establish its own distribution and sales organizations in some or all of the target foreign markets. Either way, a firm minimizes its direct investments in foreign countries because of its home-based production and export strategy.

2. Exporting may help a firm achieve experience curve and location economies. By manufacturing the product in a centralized location and exporting to other national markets, the firm may realize substantial economies from its global sales volume. This is how Sony came to dominate the global TV market.

Disadvantages of Exporting

The following are the disadvantages of exporting:

1. Exporting from the firm's home base may not be appropriate if there are lower-cost locations for manufacturing the product abroad (i.e. if the firm can realize location economies by moving production elsewhere.)
2. High transport costs can make exporting uneconomical, particularly for bulk products. One way of going around is to manufacture bulk products regionally.
3. Tariff barriers can make exporting uneconomical. Similarly the threat of tariff barriers by the host-country government can make it very risky.
4. Exporting through local agent may not be good proposition since foreign agents often carry the products of competing firms and so have divided loyalties.

Example:

1. Direct Exporting: Baskin Robbins initially exported its ice-cream to Russia in 1990 and later opened 74 outlets with Russian partners. Finally in 1995 it established its ice cream plant in Moscow.
2. Selling of products by Hindustan Lever in India to Unilever in USA- This transaction is treated as exports in India and imports in USA.

6.2.2 Licensing

Licensing makes sense when a firm with valuable technical know-how or a unique patented product has neither the internal organizational capability nor the resources to enter the foreign markets. Licensing essentially permits a company in the target country to use the property of the licensor. Such property usually is intangible, such as trademarks, patents, and production techniques. The licensee pays a fee in exchange for the rights to use the intangible property and possibly for technical assistance.

Because little investment on the part of the licensor is required, licensing has the potential to provide very large ROI. However, because the licensee produces and markets the product, potential returns form manufacturing and marketing activities may be lost.

Advantages of Licensing

The advantages of licensing are as follows:

1. Licensing has the advantage of avoiding the risks of committing resources to country markets that are unfamiliar, present considerable economic uncertainty or are politically volatile. By licensing the technology or the production rights to foreign-based firms, the firm does not have to bear the costs and risks of entering foreign markets on its own, yet it is able to generate income from royalties.
2. Licensing is often used when a firm wishes to participate in a foreign market but is prohibited from doing so by barriers to investment.
3. 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.

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Disadvantages of Licensing

Licensing has the following disadvantages:

1. The big disadvantage of licensing is the risk of providing valuable technological know-how to foreign companies and thereby loosing some degree of control over its use; monitoring licenses and safeguarding the company's proprietary know-how can prove quite difficult in some cases.
2. 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.
3. 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, a firm can quickly lose control over its technology by licensing it.

Example: Pepsi-Cola granted license to Heineken of Netherlands with exclusive rights of producing and selling Pepsi-Cola in Netherlands.

Under this agreement the boundaries are:

1. Heineken should not export Pepsi-Cola to any other country.
2. Pepsi supplies concentrated coal syrup and Heineken adds carbonated water to produce beverage.
3. Pepsi can grant license to other companies in Netherlands to produce other products of Pepsi.

Caselet

Mauritius SEZ Success Story

Since its inception over 400 firms have established themselves in sectors as diverse as textiles, food, watches and plastics. In job employment the results have been startling, as at 1987, 78,000 were employed in the EPZ. Export earnings have tripled from 1981 to 1986 and the added value has been significant. The roots of success can be seen on the supply, demand and institutional sides. On the supply side the most critical factor has been the generous financial and other incentives, on the demand side, access to the EU, France, India and Hong Kong was very tempting to investors. On the institutional side positive schemes were put in place, including finance from the Development Bank and the cutting of red tape. In setting up the export processing zone the Mauritian government displayed a number of characteristics which in hindsight, were crucial to its success.

1. The government intelligently sought a development strategy in an apolitical manner.
2. It stuck to its strategy in the long run rather than reverse course at the first sign of trouble.
3. It encouraged market incentives rather than undermined them.
4. It showed a good deal of adaptability, meeting each challenge with creative solutions rather than maintaining the status quo.

Contd...

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5. It adjusted the general export promotion programme to suit its own particular needs and characteristics.
6. It consciously guarded against the creation of an unwieldy bureaucratic structure.

Source: http://www.fao.org/docrep/W5973E/w5973e0b.htm

6.2.3 Franchising

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 how it does business. The franchiser will also often assist the franchisee to run the business on an ongoing basis.

While licensing works well for manufacturers, franchising is often suited to the global expansion efforts of service and retailing.

The franchisor provided the following services to the franchisee:

1. Trade marks,
2. Operating system,
3. Product reputations,
4. Continuous support systems like advertising, employee training, reservation services, quality assurance programmes etc.

Advantages of Franchising

Franchising has much the same advantages as licensing. The franchisee bears most of the costs and risks of establishing foreign locations; the franchiser has to expend only the resource to recruit, train, and support franchisees. 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 of Franchising

The big problem a franchiser faces is maintaining quality control; foreign franchisees do not always exhibit strong commitment to consistency and standardization, perhaps because the local culture does not stress or put much value on the same kinds of quality concerns.

Example: McDonald's, Tricon Global Restaurants (the parent of Pizza Hut, Kentucky Fried Chicken, and Taco Bell), and Hilton Hotels have all used franchising to build a presence in foreign markets.

Self Assessment

Fill in the blanks:

1. Exporting may help a firm achieve ……. and …….
2. ……. projects are a way of earning great economic returns from the assets.
3. The optimal entry mode for the firms depends to some degree on the nature of their …….
4. ……. barriers can make exporting uneconomical.
5. ……. is often used when a firm wishes to participate in a foreign market but is prohibited from doing so by barriers to investment.

Notes

6.2.4 Contract Manufacturing

To attempt to have the best of both worlds, more and more companies are adopting an import strategy which uses *contract manufacturing abroad*. Instead of simply ordering products as needed, the company enters into a contract with the foreign supplier, which fixes production amounts and delivery times and allows the supplier to maintain hands-on management of the production process. This gives the importer a greater assurance of supply and quality control while capitalizing on lower wage rates and still limiting the company's commitment to the manufacturer and the country of manufacture. This program can be used either to acquire a lower-cost source of components or for a production base for final assembly of products.

Benefits of Contract Manufacturing

In contractual agreements between a principal and a foreign market-based manufacturer who produces branded products, both the principal and sub-contractor expect to benefit.

1. For the principal, contract manufacturing offers access to raw materials and cheap labour supply, flexible production planning, and the opportunity to circumvent restrictive employment legislation in the host country.
2. For the sub-contractor, there are a number of benefits; the opportunity to create and sustain additional employment, and manufacture to international standards.
3. In cases where manufactured products are re-exported to third markets, contract manufacturing is encouraged by the host government as it contributes to improved balance of trade.

Limitations of Contract Manufacturing

It may be very difficult to find suitable sub-contractors in the host market whose facilities, equipment and know-how are compatible with the requirements of the principal.

1. The principal may not have direct supervisory control over the manufacturing process. This can lead to serious problems of quality control.
2. Contract execution and supply of merchandise may be disrupted either by local political upheavals or industrial relations difficulties in the host market.
3. For a sub-contractor largely dependent on the principal, termination of contract by the principal could cause short-term difficulties and might lead to bankruptcy in the long run.

Example: Nike has contracted with a number of factories in south-east Asia to produce its athletic footwear and it concentrates on marketing.

Bata also contracted with a number of cobblers in India to produce its footwear and concentrate on marketing.

Mega Toys- a Los Angels based company contracts with Chinese plants to produce toys and Mega toys concentrates on marketing.

Notes

Caselet **Euro Disney**

Different modes of entry may be more appropriate under different circumstances, and the mode of entry is an important factor in the success of the project. Walt Disney Co. faced the challenge of building a theme park in Europe. Disney's mode of entry in Japan had been licensing. However, the firm chose direct investment in its European theme park, owning 49% with the remaining 51% held publicly.

Besides the mode of entry, another important element in Disney's decision was exactly where in Europe to locate. There are many factors in the site selection decision, and a company carefully must define and evaluate the criteria for choosing a location. The problems with the EuroDisney project illustrate that even if a company has been successful in the past, as Disney had been with its California, Florida and Tokyo theme parks, future success is not guaranteed, especially when moving into a different country and culture. The appropriate adjustments for national differences always should be made.

Source: http://www.quickmba.com/strategy/global/marketentry/

6.2.5 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 handled 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 of Turnkey Projects

Turnkey projects has the following advantages:

1. Turnkey projects are a way of earning great economic returns from the 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 and refining sectors. But because many of these countries lacked petroleum technology; they gained it by entering into turnkey projects with foreign firms than had the technology.
2. 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 of Turnkey Projects

Some of the disadvantages of turnkey projects are mentioned below:

1. 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.
2. The firm that enters into a turnkey project with a foreign enterprise may inadvertently create a competitor.

Notes

3. 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.

Task Is it important to keep a maximum significant interaction between the parties to alliance? Why?

6.3 Strategic Alliances

A strategic alliance is a formal relationship between two or more parties to pursue a set of agreed upon goals or to meet a critical business need while remaining independent organizations. Strategic alliances are agreements between companies (partners) to reach objectives of a common interest. Alliances are among the various options, which companies can use to achieve their goals; they are based on co-operation between companies.

Generally, strategic alliances are arrangements between two or more entities that are created to achieve mutual goals through collaboration. Strategic alliances take many forms, including contractual arrangements (such as license agreements, marketing agreements, and development agreements), minority equity investments, and joint ventures that are operated as separate legal entities (such as corporations, limited liability companies, or partnerships). Regardless of the form, strategic alliances share common features such as:

1. Defined scope and strategic objectives;
2. Interdependent contractual arrangements within the defined scope and to achieve the strategic goals;
3. Specifically defined responsibilities and commitments for each party;
4. Independence of the parties outside of the defined scope of the alliance;
5. A fixed time period in which to achieve the strategic goals.

The simplest form of strategic alliance is a contractual arrangement. Contractual-based strategic alliances generally are short-term arrangements that are appropriate when a formal management structure is not required. While the specific provisions of the contract will depend upon the business arrangement, the contract should address:

1. The duties and responsibilities of each party,
2. Confidentiality and non-competition,
3. Payment terms,
4. Scientific or technical milestones,
5. Ownership of intellectual property,
6. Remedies for breach, and
7. Termination.

Example: Contractual strategic alliances are license agreements, marketing, promotion, and distribution agreements, development agreements, and service agreements.

The most complex form of strategic alliance is a joint venture. A joint venture involves creating a separate legal entity (generally a corporation, limited liability company, or partnership) through which the business of the alliance is conducted. A joint venture may be appropriate if:

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1. The parties intend a long-term alliance;
2. The alliance will require a significant commitment of resources by each party;
3. The alliance will require significant interaction between the parties;
4. The alliance will require a separate management structure;
5. If the business of the alliance may be subject to unique regulatory issues;
6. In addition, a joint venture will be appropriate if the parties expect that the alliance ultimately may be able to function as a separate business that could be sold or taken public.

Historically, information technology and life sciences companies have sought minority equity investments from strategic commercial partners. This form of strategic alliance has gained increased popularity in the current economic climate. In many cases, the equity investment will also be accompanied by a contractual arrangement between the parties such as a license agreement or a distribution agreement. From the company's perspective, an equity investment from a strategic commercial partner may be structured on more favorable terms than those obtained from venture capitalists, and it may increase the company's valuation and enhance the company's ability to secure future rounds of funding. Venture capitalists and underwriters generally view these types of strategic alliances as validating an early stage company's technology and business model. In some cases, they have even become a condition to an underwriter taking a life science company public. The strategic commercial partner may desire this form of alliance to gain a competitive advantage through access to new technologies and to share in the upside of the other party's business through equity ownership.

Early stage companies may gain significant operational advantages as a result of forming strategic alliances. Moreover, the growth of early stage companies may be significantly accelerated through strategic alliances, and the companies may be more successful in obtaining future equity investments. In addition, early stage companies may find that strategic alliances are the first step to the acquisition of the company by the strategic partner, and they give the parties the opportunity to evaluate whether or not an acquisition is desirable.

Strategic alliances also have their risks, particularly if the parties are not financial equals. These risks include the loss of operational control and confidentiality of proprietary information and technology. Some alliances can involve a clash of corporate cultures or the perceived diminution of independence. In addition, the parties may deprive themselves of future business opportunities with competitors of their strategic partner.

The parties must carefully consider a number of factors in the decision of whether to enter into a strategic alliance, and how best to govern the relationship once the alliance is formed. In addition to the parties' business objectives, the parties should consider a variety of accounting, tax, antitrust, and intellectual property issues when structuring a strategic alliance. A properly structured strategic alliance can bring many new opportunities and enhance the parties' growth potential. In addition, it can provide an alternative source of capital during difficult economic times.

6.3.1 Stages of Alliance Formation

A typical strategic alliance formation process involves these steps:

Alliance Operation: Alliance operations involves addressing senior management's commitment, finding the calibre of resources devoted to the alliance, linking of budgets and resources with strategic priorities, measuring and rewarding alliance performance, and assessing the performance and results of the alliance.

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Alliance Termination: Alliance termination involves winding down the alliance, for instance when its objectives have been met or cannot be met, or when a partner adjusts priorities or re-allocated resources elsewhere.

Contract Negotiation: Contract negotiations involves determining whether all parties have realistic objectives, forming high calibre negotiating teams, defining each partner's contributions and rewards as well as protect any proprietary information, addressing termination clauses, penalties for poor performance, and highlighting the degree to which arbitration procedures are clearly stated and understood.

Partner Assessment: Partner assessment involves analyzing a potential partner's strengths and weaknesses, creating strategies for accommodating all partners' management styles, preparing appropriate partner selection criteria, understanding a partner's motives for joining the alliance and addressing resource capability gaps that may exist for a partner.

Strategy Development: Strategy development involves studying the alliance's feasibility, objectives and rationale, focusing on the major issues and challenges and development of resource strategies for production, technology, and people. It requires aligning alliance objectives with the overall corporate strategy.

6.3.2 Why Alliances are more common now?

The drive to create alliances has evolved quickly over the last few decades.

In the 70's, the main factor was the performance of the product. Alliances aimed to acquire the best raw material, the lowest costs, the most recent technology and improved market penetration internationally, but the mainstay was the product.

In the 80's, the main objective became consolidation of the company's position in the sector, using alliances to build economies of scale and scope. In this period there was a true explosion of alliances. The one between Boeing and a consortium of Japanese companies to build the fuselage of the passenger.

Transport version of the 767; the alliance between Eastman Kodak and Canon, which allowed Canon to produce a line of photocopiers sold under the Kodak brand; an agreement between Toshiba and Motorola to combine their respective technologies in order to produce microprocessors.

In the 90's – according to Harbison and Pekar (1998) – collapsing barriers between many geographical markets and the blurring of borders between sectors brought the development of capabilities and competencies to the center of attention. It was no longer enough to defend one's position in the market. It became necessary to anticipate one's rivals through a constant flow of innovations giving recurrent competitive advantage.

It is easy to predict that various factors will contribute to the diffusion of alliances in the coming years as well.

1. Acceleration of the rhythms of technological innovation and shortening of product life cycles.
2. The convergence of technologies and the "permeability" of borders between sectors and between markets.
3. Progress in telecommunications.
4. Strong improvements in R&D costs, new product launches, tools and systems.
5. The collapse of many barriers to competition, on account of deregulation, privatization and globalization.

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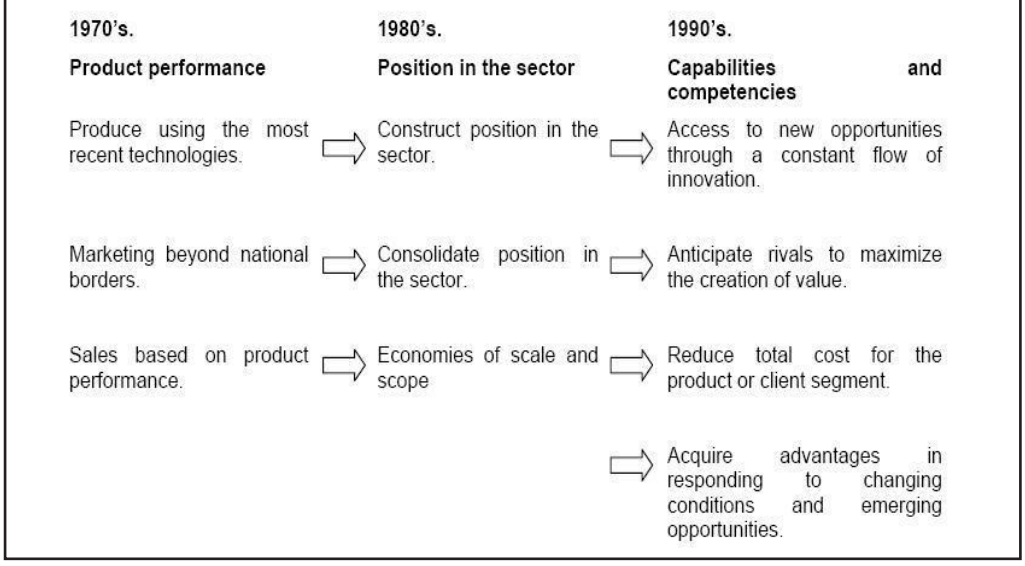
6. The interest of governments in attracting foreign capital and technologies without ceding control of local companies to foreigners.

Figure 6.1: Evolution of Factors Leading to Alliances



6.3.3 Goals of Alliances

Alliances include a wide variety of goals which companies are completely or partially precluded from achieving when confronting competition on their own.

Setting New Global Standards

Entering into an alliance can be the best way to establish standards of technology in the sector.

PHILIPS-SONY

In the late 80's, Philips was in essence pushed out the VCR market, when Japanese producers managed to impose their standards. To avoid new defeats, Philips created various alliances with Japanese rivals to assure technological compatibility among European and Japanese products.

The compact disc (CD) was designed with a global standard by virtue of a series of alliances:

1. Between Philips and Sony, which not only contributed to the planning of the CD and sound reproduction, but with its presence in the alliance dissuaded other Japanese producers from seeking alternative solutions?
2. To spread usage of the CD and the standard, Philips ceded the production licensing in exchange for modest royalties.
3. Philips and DuPont made a 50-50 joint venture to produce and sell optics components for the audio-video market.
4. Philips and Sony jointly launched the mini-CD.

Notes

Confronting Competition

When a high-volume producer decides to attack a new geographic market, defense is difficult if it does not have comparable size. Alliance between companies is a response which has often led to positive results. It is equally valid to attempt an attack on a leader that has consolidated its own positions.

CLARK-VOLVO

In the earthmover sector, neither Clark Equipment nor Volvo had enough production volume (the former in the United States, the latter in Europe) to take on the global leaders Caterpillar and Komatsu. In the mid-80's they decided to create an alliance.

Overcoming Protectionist Barriers

Alliances can allow companies to avoid controls on importation and overcome barriers to commercial penetration. For example, in Japan many companies have established that the best and fastest way to achieve success in the market is to make an alliance with a local company. In fact, the distribution system is controlled by a tightly-woven network of producers, distributors and importers. Only an alliance with one of these can open the road to the final buyer.

Alliances can also be a way to respect the bonds posted by the "host" country regarding value-added local content and participation in the capital of local businesses.

Dividing Risks

For certain projects, risks of failure are high, and even higher when investments are elevated.

CFM International: The alliance (50-50 joint venture) between General Electric and Snecma was made to plan, develop and produce a new airplane propeller. Over ten years of R&D work and more than two billion dollars were necessary to sell the first engine.

Economy of Scale

There are many alliances designed to divide fixed costs of production and distribution, seeking to improve volume. The alliances between airlines to manage reservation systems (Computer Reservation Systems) jointly are among the most notable examples.

6.3.4 Advantages of Strategic Alliance

In the past, joint ventures focused on the representation of companies in various countries or geographic areas. In the past decades, the phenomenon of joint ventures for predefined activities has become more prevalent. An alliance can impart to the company a relative advantage in size or an ability to learn the field faster, or provide a complement to areas in which it is lacking.

Example: An alliance between a startup with an advantage in development and production with a company with proven marketing skills.

When the joint venture is performed in a formal manner, by establishing a separate legal entity for it (also known as the joint venture), it is similar in nature to a partial acquisition in consideration for shares. This is because the transaction creates an entity that combines the relative advantages of both parties and ties their futures together, at least with respect to the field in question.

Notes

Many startups decide that the best way to rapidly expand their business is to enter into strategic alliances with established companies which serve a different but similar market. The many benefits of strategic alliances are listed below:

1. Access to distribution channels,
2. Access to technology, expertise or intellectual property,
3. As a means to raise capital,
4. New products for your customers,
5. Lower R&D costs,
6. Economies of scale, and
7. Raise brand awareness.

6.3.5 Disadvantages of Strategic Alliance

Alliances are costly, not only due to cash leaving the company's hands, but rather due to returns from which it could be denied. First, joint ventures involve the investment of managerial time resources in establishing the venture, managing it, and resolving possible conflicts of interest between the partners over the functioning of the venture. Even when a proper set of contracts, incentive schemes, and various transfer prices from the partners to the joint venture resolve most conflicts, almost no joint venture manages to entirely avoid conflicts between its respective parties.

Moreover, alliances can create indirect costs by blocking the possibility of cooperating with competing companies, thus possibly even denying the company various financing options.

Example: An alliance with Ericsson in the area of cellular communications could reduce the likelihood of contracts with Nokia, thereby putting the company at risk that if Ericsson is weakened, so will be all the companies that depend upon it.

Joint ventures also expose the company to its partners, and the unique technologies that it has are sometimes revealed to its partner company, which could later become a competitor or could utilize the fruits of the venture or the know-how better than the startup itself. In addition, strategic partners may often lead the company in directions that serve the partner company better than they do the company itself.

Although a material part of the costs of joint ventures may be forecasted during the negotiations for its establishment, in many cases the balance of power between the parties changes during the course of the venture's life, and the parties to it may have a change of mind. For instance, many joint ventures that were signed before the stock market crises of 2001-2002 between public companies and startups never materialized due to the drop in the stock prices of some such public companies. The fact that some of the private companies had meanwhile raised capital and actually had become stronger than the public companies, utterly changed the balance of power. Likewise, the non-raising of capital by the startup could motivate the public company to try to renegotiate the terms of the venture, while taking advantage of the startup's weakness. A change in the competitive environment in the field could also affect the alternative cost of the venture.

Example: If Nokia were to increase its share in the cellular market, then the alternative cost of the venture with Ericsson (namely, the economic value of the reduced opportunity to do business with Nokia) would be augmented overtime.

The problem with strategic alliances is that there are a number of problems which must be overcome for them to be a success, including:

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1. Incoherent goals, with one business not benefiting greatly from the agreement;
2. Insufficient trust, with each partner company trying to get the better deal;
3. Conflicts over how the partnership works;
4. Potential to reduce future opportunities through being unable to enter into agreements with your partner's competitors;
5. Lack of commitment to the partnership; and
6. Risk of sharing too much knowledge and the partner company becoming a competitor.

The main problem with strategic alliances is being able to develop a partnership which is beneficial to both parties. Often a partnership is beneficial to the smaller business, perhaps due to the wide-scale distribution channels that are gained, but the benefits for the established business aren't quite so clear.

Example: Examples of strategic alliance

India's TCS and Cisco form Strategic Alliance

1. India's largest software exporter Tata Consultancy Services (TCS) and US networking giant Cisco Systems announced an alliance Tuesday to help their customers build next-generation data centres.
2. Cisco will create its own technology lab on the Tata group company's campus in the southern city of Chennai as part of the strategic alliance.
3. Both companies declined to provide financial details of the alliance, which will focus on India, US and British-based customers in the banking, financial services, telecom and state sectors.
4. "The alliance offers multibillion-dollar opportunities," TCS Chief Executive S. Ramadorai told reporters in Mumbai, without giving precise forecasts.
5. "We believe in catching markets in transition, which makes this alliance crucial," said John Chambers, Chairman and Chief Executive of Cisco.
6. "If I had to bet on one country at this moment, it would be India," Chambers said, adding he was confident of India's future strong economic growth.
7. Cisco, which has been in India for over a decade and is a dominant player in the Internet networking market, had earlier pledged to invest 1.2 billion dollars in the country.
8. It has said it plans to turn the South Asian nation into a platform to service markets worldwide.
9. Cisco is trying to take advantage of India's low costs, its pool of technology talent pool and the expertise of local companies to seize new markets.

6.3.6 Recent Mergers and Acquisitions

Mergers and acquisitions have been very common incidents since the turn of the 20th century. These are used as tools for business expansion and restructuring. Through mergers the acquiring company gets an expanded client base and the acquired company gets additional lifeline in the form of capital invested by the purchasing company. The recent mergers and acquisitions authenticate such a view.

Notes

Example:

1. The Long Success International (Holdings) Ltd. merged with City Faith Investments Ltd on the 8th of April 2008. The value of the merger was US $3.2 million. The agency in this instance was Bermuda Monetary Authority, Hong Kong Stock Exchange and other regulatory authority that was unspecified.
2. Novartis AG acquired 25% stake in Alcon Inc. This acquisition was worth 73,666 million common shares of the company. They bought this stake from Nestle SA for $10.547 billion by paying $143.18 for every share. It was a privately negotiated transaction that needed to have a regulatory approval. Simultaneously, Novartis AG also received an offer of 52% interest that was equivalent of 153.225 million common shares of Alcon Inc.
3. Kinetic Concepts acquired each and every remaining common stock of LifeCell Corp for $51 for each share. Their total offer was $1.743 billion. The deal was done in accordance to regulatory approvals and the conventional closing conditions.
4. Kapstone Paper & Packaging Corp acquired the kraft paper mill as well as other assets of MeadWestVaco.Corp. They paid them $485 million. The deal was conducted as per the regulatory approvals, receipt of financing and conventional closing conditions. This deal included a lumber mill in Summerville, hundred percent interest in Cogen South LLC. The Chip mills in Kinards, Elgin, Andrews and Hampton in South Carolina are also parts of this deal.
5. Petrofalcon Corp acquired the remaining shares of Anadarko Venezuela Co from Anadarko Petroleum Corp. The deal was worth 428.46 million Venezuelan bolivar or US $200 million. The deal was completed as per the regulatory approvals.
6. Discover Financial Services, LLC acquired Diners Club International Ltd from Citigroup Inc. The deal was worth US $165 million. The deal was subjected to regulatory approvals and normal closing conditions. Cobham PLC took over MMI Research Ltd. The deal was worth $16.6 million or $33.099 million. In this deal $12.2 was paid in cash, $1.4 million in loan notes and almost $3 million in payments related to profits.
7. WNS (Holdings) Ltd from India, took over the total share capital of Chang Ltd. The deal was worth $9.6 million. Of this amount $8 million was to be paid in cash and the rest was to be paid in payments related to profits.
8. AptarGroup Inc acquired the Advanced Barrier System wing of the CCL Industries Inc. The deal was worth almost 9.4 million Canadian dollars. The entire amount was paid on cash. Varian Inc from USA took over 23% stakes of Oxford Diffraction Ltd. The deal was worth $4.6 million pounds. $3.5 million was paid in cash, and the rest was to be paid from the profits made by the company.
9. Spice PLC took over Melton Power Services Limited. The deal was worth $4.5 million. $2.5 million was paid in cash and the rest was to be paid from the profits made by the company. Spice PLC also got Utility Technology Ltd., GIS Direct Ltd, and Line Design Solutions Ltd as part of the deal.

Self Assessment

Fill in the blanks:

6. The optimal entry mode for the firms depends to some degree on the nature of their core competencies. A distinction can be drawn between firms whose core competency is in …… and those whose core competency is in …….
7. When …… constitutes a firm's core competence, foreign franchise controlled by joint ventures seems to be optimal.

Notes

6.4 Foreign Direct Investment (FDI)

Foreign direct investment is direct investment into production in a country by a company located in another country, either by buying a company in the target country or by expanding operations of an existing business in that country. Foreign direct investment is done for many reasons including to take advantage of cheaper wages in the country, special investment privileges such as tax exemptions offered by the country as an incentive to gain tariff-free access to the markets of the country or the region. Foreign direct investment is in contrast to portfolio investment which is a passive investment in the securities of another country such as stocks and bonds.

As a part of the national accounts of a country, and in regard to the national income equation Y=C+I+G+(X-M), I is investment plus foreign investment, FDI refers to the net inflows of investment (inflow minus outflow) to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, other long-term capital, and short-term capital as shown the balance of payments. It usually involves participation in management, joint-venture, transfer of technology and expertise. There are two types of FDI: inward foreign direct investment and outward foreign direct investment, resulting in a net FDI inflow (positive or negative) and "stock of foreign direct investment", which is the cumulative number for a given period. Direct investment excludes investment through purchase of shares. FDI is one example of international factor movements.

Foreign firm needs a control the operation when:

1. It has foreign firm's need to control the operations when it has subsidiaries to achieve strategic synergies.
2. The technology, manufacturing expertise, intellectual property rights have potentialities and their full utilization needs planned exploitation.

6.4.1 Advantages of FDI

The following are the advantage of FDI:

1. Mostly the customer on host country prefer the products produced in their country like: be Indian, buy Indian. In such cases FDI helps the company to gain market through this mode rather than other modes.
2. Purchase managers of most of the companies prefer to buy local production in order to ensure certainty of supply, faster services, quality dependability, and better communication with the suppliers.
3. The company can produce based on the local environment and changing preference of the customers.

6.4.2 Disadvantages of FDI

The following are the disadvantages of FDI:

1. FDI expose the company to the host country's political and economic risk.
2. FDI expose the company to the exchange rate fluctuation.
3. Some countries discourage the entry of foreign companies though FDI in order to protect the domestic industry.
4. Changing government policies of the host country may create uncertainty to the company.
5. Host country government sometimes bans the acquisition of local companies by foreign companies; impose restriction on repatriation of dividends and capital. India has allowed 100% convertibility.

Notes

6.5 Mergers and Acquisitions

Mergers and acquisitions refers to the aspect of corporate strategy, corporate finance and management dealing with the buying, selling and combining of different companies that can aid, finance, or help a growing company in a given industry grow rapidly without having to create another business entity.

Merger is a tool used by companies for the purpose of expanding their operations often aiming at an increase of their long term profitability. There are 15 different types of actions that a company can take when deciding to move forward using M&A. Usually mergers occur in a consensual (occurring by mutual consent) setting where executives from the target company help those from the purchaser in a due diligence process to ensure that the deal is beneficial to both parties. Acquisitions can also happen through a hostile takeover by purchasing the majority of outstanding shares of a company in the open market against the wishes of the target's board. In the United States, business laws vary from state to state whereby some companies have limited protection against hostile takeovers. One form of protection against a hostile takeover is the shareholder rights plan, otherwise known as the "poison pill".

Historically, mergers have often failed to add significantly to the value of the acquiring firm's shares. Corporate mergers may be aimed at reducing market competition, cutting costs (for example, laying off employees, operating at a more technologically efficient scale, etc.), reducing taxes, removing management, "empire building" by the acquiring managers, or other purposes which may or may not be consistent with public policy or public welfare.

Caution Mergers and Acquisitions do not have a very successful history in providing corporate growth platform for many businesses.

Distinction between Mergers and Acquisitions

When one company takes over another and clearly establishes itself as the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist, the buyer "swallows" the business and the buyer's stock continues to be traded.

In the pure sense of the term, a merger happens when two firms, often of about the same size, agree to go forward as a single new company rather than remain separately owned and operated. This kind of action is more precisely referred to as a "merger of equals". Both companies' stocks are surrendered and new company stock is issued in its place.

Example: In the 1999 merger of Glaxo Wellcome and SmithKline Beecham, both firms ceased to exist when they merged, and a new company, GlaxoSmithKline, was created.

International Mergers and Acquisitions

International mergers and acquisitions are growing day-by-day. These mergers and acquisitions refer to those mergers and acquisitions that are taking place beyond the boundaries of a particular country. International mergers and acquisitions are also termed as global mergers and acquisitions or cross-border mergers and acquisitions.

Globalization and worldwide financial reforms have collectively contributed towards the development of international mergers and acquisitions to a substantial extent. International mergers and acquisitions are taking place in different forms, for example horizontal mergers, vertical mergers, conglomerate mergers, congeneric mergers, reverse mergers, dilutive mergers, accretive mergers and others.

Notes

International mergers and acquisitions are performed for the purpose of obtaining some strategic benefits in the markets of a particular country. With the help of international mergers and acquisitions, multinational corporations can enjoy a number of advantages, which include economies of scale and market dominance.

International mergers and acquisitions play an important role behind the growth of a company. These deals or transactions help a large number of companies penetrate into new markets fast and attain economies of scale. They also stimulate foreign direct investment or FDI.

The reputed international mergers and acquisitions agencies also provide educational programs and training in order to grow the expertise of the merger and acquisition professionals working in the global merger and acquisitions sector.

The rules and regulations regarding international mergers and acquisitions keep on changing constantly and it is mandatory that the parties to international mergers and acquisitions get themselves updated with the various amendments. Numerous investment bank professionals, consultants and attorneys are there to offer valuable and knowledgeable recommendations to the merger and acquisition clients.

Task Exemplify latest successful merger or acquisition.

6.5.1 Advantages of Mergers and Acquisitions

Merger refers to the process of combination of two companies, whereby a new company is formed. An acquisition refers to the process whereby a company simply purchases another company. In this case there is no new company being formed. Benefits of mergers and acquisitions are quite a handful.

1. Mergers and acquisitions generally succeed in generating cost efficiency through the implementation of economies of scale. It may also lead to tax gains and can even lead to a revenue enhancement through market share gain.
2. The principal benefits from mergers and acquisitions can be listed as increased value generation, increase in cost efficiency and increase in market share.
3. Mergers and acquisitions often lead to an increased value generation for the company. It is expected that the shareholder value of a firm after mergers or acquisitions would be greater than the sum of the shareholder values of the parent companies.
4. An increase in cost efficiency is effected through the procedure of mergers and acquisitions. This is because mergers and acquisitions lead to economies of scale. This in turn promotes cost efficiency. As the parent firms amalgamate to form a bigger new firm the scale of operations of the new firm increases. As output production rises there are chances that the cost per unit of production will come down.
5. An increase in market share is one of the plausible benefits of mergers and acquisitions. In case a financially strong company acquires a relatively distressed one, the resultant organization can experience a substantial increase in market share. The new firm is usually more cost-efficient and competitive as compared to its financially weak parent organization.

Notes

6.5.2 Disadvantages of Mergers and Acquisitions

The disadvantages are:

1. Uncertainty about target's value.
2. Difficulty in absorbing acquired assets.
3. Infeasible if local market for corporate control is underdeveloped.
4. This strategy adds no capacity to the industry.
5. Labour problems of the host country's company are also transferred to the acquired company.

6.5.3 Mergers and Acquisitions in India: the Latest Trends

Till recent past, the incidence of Indian entrepreneurs acquiring foreign enterprises was not so common. The situation has undergone a sea change in the last couple of years. Acquisition of foreign companies by the Indian businesses has been the latest trend in the Indian corporate sector.

There are different factors that played their parts in facilitating the mergers and acquisitions in India. Favourable government policies, buoyancy in economy, additional liquidity in the corporate sector, and dynamic attitudes of the Indian entrepreneurs are the key factors behind the changing trends of mergers and acquisitions in India.

The Indian IT and ITES sectors have already proved their potential in the global market. The other Indian sectors are also following the same trend. The increased participation of the Indian companies in the global corporate sector has further facilitated the merger and acquisition activities in India.

Self Assessment

State whether the following statements are true or false:

8. International mergers and acquisitions are growing day-by-day.
9. An acquisition refers to the process whereby a company simply purchases another company.
10. Strategic alliance does not provide help in technology transfer.
11. Joint venture does not improve access to financial resources.

6.6 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 popular mode for entering a new 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 mangers to share operating control.

Notes A joint venture entails establishing a firm that is jointly owned by two or more otherwise independent firms.

Notes

6.6.1 Reasons for Joint Venture Formation

There are mainly three reasons for JV formation and these are:

1. ***Internal Reasons:*** The internal reasons are:
   (a) Build on company's strengths,
   (b) Spreading costs and risks,
   (c) Improving access to financial resources,
   (d) Economies of scale and advantages of size,
   (e) Access to new technologies and customers, and
   (f) Access to innovative managerial practices.
2. ***External Reasons:*** The external reasons are:
   (a) Influencing structural evolution of the industry,
   (b) Pre-empting competition,
   (c) Defensive response to blurring industry boundaries,
   (d) Creation of stronger competitive units,
   (e) Speed to market, and
   (f) Improved agility.
3. ***Strategic Reasons:*** The strategic reasons are:
   (a) Synergies,
   (b) Transfer of technology/skills, and
   (c) Diversification.

6.6.2 When Joint Ventures Used?

Joint ventures are not uncommon in the oil and gas industry, and are often cooperations between a local and foreign company (about 3/4 are international). A joint venture is often seen as a very viable business alternative in this sector, as the companies can complement their skill sets while it offers the foreign company a geographic presence. Studies show a failure rate of 30-61%, and that 60% failed to start or faded away within 5 years. (Osborn, 2003) It is also known that joint ventures in low-developed countries show a greater instability, and that JVs involving government partners have higher incidence of failure (private firms seem to be better equipped to supply key skills, marketing networks etc.) Furthermore, JVs have shown to fail miserably under highly volatile demand and rapid changes in product technology.

Did u know? Many countries including our own India require foreign companies to form JVs in order to enter domestic markets.

6.6.3 Advantages of Joint Ventures

1. First, a firm benefits from a local partner's knowledge of the host country's competitive conditions, culture, language, political systems and business systems.
2. 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.

Notes

3. Third, in many countries, political considerations make joint ventures the only feasible entry mode.

6.6.4 Disadvantages of Joint Ventures

As with licensing, a firm that enters into a joint venture risks giving control of its technology to its partner.

1. 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.

2. Shared ownership arrangements can lead to conflicts and battles for control between the investing firms in their goals and objectives change or if they take different views as to what the strategy should be.

Example:

Massey-/Ferguson entered into a 51% joint venture in Turnkey to produce Tractors.

American Motor Corporation entered into a joint venture with Beijing Automotive Works called Beijing Jeep to enter Chinese market by producing jeeps and other vehicles.

6.6.5 Comparison of Different Modes of Entry

Advantages and Disadvantages associated with all the entry modes are summarized in Table 6.1 below:

Table 6.1

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.

Notes

Due to this advantages and disadvantages, trade-offs are inevitable when selecting an entry mode.

Caution Firm, in a joint venture have limited access over subsidiaries.

Self Assessment

Fill in the blanks:

12. The simplest form of strategic alliance is a …… .
13. ……. involves determining whether all parties have realistic objectives, forming high calibre negotiating teams.
14. A ……. is an entity formed between two or more parties to undertake economic activity together.
15. ……. is a tool used by companies for the purpose of expanding their operations often aiming at an increase of their long term profitability.

Caselet

The P & G – Godrej Split

In late 1992, the American FMCG (Fast Moving Consumer Goods) giant, Procter & Gamble (P & G) and a leading Indian business group, Godrej set up a marketing joint venture, P&G – Godrej (PGG) in which P&G held a 51% stake and Godrej the remaining 49%. David Thomas, P&G's country manager in India was appointed as CEO while Adi Godrej, the head of the Indian company, became the chairman.

P&G paid Godrej roughly ₹ 50 crores to acquire its detergent brands, Trilo, Key and Ezee. Godrej became the sole supplier to the joint venture on a cost plus basis. P&G, on its part, gave a commitment that it would utilise Godrej's soap making capacity of 80,000 tonnes per annum. Godrej was allowed to complete its existing manufacturing contracts for two other MNCs, Johnson & Johnson and Reckitt & Coleman, but could not take up any new contracts. P&G, on its part, would not appoint any other supplier until Godrej's soap making capacity had been fully utilised. Godrej transferred 400 of its sales people to the joint venture.

For both sides, the joint venture seemed to make a lot of sense. P&G got immediate access to Godrej's soap making facilities. It would have taken P&G at least a couple of years to implement a greenfield project. Godrej also had expertise in vegetable oil technology for making soaps. This expertise was useful in a country like India, where beef tallow could not be used and soap manufacturers had to depend on vegetable oil such as palm oil and rice bran oil. P&G also gained immediate access to a well connected distribution network consisting of some two million outlets. Even though P&G had been around in India for sometime, its Indian operations were essentially those of the erstwhile Richardson Hindustan, which dealt primarily in pharmaceutical products such as Vicks. The non-pharma distribution network of Godrej, acted as a fine complement to P&G's existing pharma network. Godrej, on the other hand, was struggling with unutilised capacity. Godrej also hoped to pick up useful knowledge from P&G, in areas such as manufacturing, brand management and surfactant technology. In short, it looked as though the joint venture had created a win-win situation, with tremendous learning opportunities, for both partners.

Contd...

Notes

The P&G Godrej alliance became operational in April 1993. Around this time, P&G increased its stake in its Indian subsidiary P&G (India) from 51% to 65%, while Godrej, after having operated for several years as a private company, went public. P&G engineers introduced new systems such as Good Manufacturing Practices and Material Resources Planning in Godrej plants. The two companies seemed to show a considerable amount of sensitivity to the cultural differences between them. For about a year, it looked as though things were going fine. Thereafter, elements of distrust began to surface and the two companies found the differences in management styles too significant to be brushed aside. By December, 1994, rumours were rife that P&G and Godrej did not see eye to eye on many key issues.

One of the main problems that the joint venture faced was that performance did not match up to expectations. In 1992, Godrej had sold 29,000 tonnes of soap. After increasing to 46,000 in 1994 the figure declined sharply to 38,000 tonnes in 1995. While sales volumes did not pick up as expected, costs began to rise. Due to the cost plus agreement, Godrej had little incentive to cut costs. Informed sources felt that Godrej was charging ₹ 10,000 more per tonne than the accepted processing costs. Godrej, on its part, was unhappy that P&G was not doing enough to promote brands like Key and Trilo that it had nurtured over the years. It was also uncomfortable with P&G's methodical and analytical approach as opposed to its own instinctive method of launching brands at breakneck speed. P&G, on its part, felt that there was little logic or coordination in Godrej's brand building exercises. Its multinational, worldwide policy set its own priorities, as explained by a P&G executive: "We believe in introducing long-term brands with sustainable consumer propositions. Without that, we just don't know how to sell." By mid 1994, sharp differences had developed between P&G and Godrej. A senior Godrej executive, H.K. Press, on deputation to the joint venture, was quietly eased out and sent back to a Godrej group company.

A report in a leading Indian magazine aptly summed up the situation: "In an atmosphere of fraying trust, the advantages of the alliance faded into the background." P&G realized it had gained distribution strengths but found itself locked into an unsustainable manufacturing agreement and a loss making joint venture. Godrej felt let down on two counts. "The capacity was not being utilised as guaranteed and more crucially, P&G's manufacturing process was not delivering any benefit to Godrej's painstakingly built portfolio of brands."

In late 1996, P&G and Godrej announced that the alliance was being terminated. The two companies would have little to do with each other, except for Godrej continuing to make Camay on behalf of P&G for two more years and providing office space to P&G at its Vikhroli complex. PGG would be taken over by P&G, which would also retain the detergent brands, Trilo, Key and Ezee. Most of PGG's 550 people and the distribution network consisting of some 3000 stockists would stay with P&G. Godrej would absorb about 100 sales people and get back its seven soap brands, which had been leased to PGG.

Both P&G and Godrej felt that the amicable parting of ways made sense. Adi Godrej remarked: "This will enable us to pursue business expansion opportunities that have occurred as a result of liberalization." David Thomas explained that the parting of ways would enable "both parties to independently pursue the broad array of growth prospects offered by the strong pace of economic reform."

Source: www.vedpuriswar.org/.../GoingGlobal/Chapter%2006_...

6.7 Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- Basic entry decisions include identifying which markets to enter, when to enter those markets, and on what scale.

Notes

- 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.
- 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.
- Each mode has relative advantages and disadvantages. The optimal choice of entry mode depends on the firm's strategy.
- Relative to green-field ventures, 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 culture of the acquiring and acquired firms clash, when there is a high level of management attention after the acquisition, and where there is a failure to integrate the operations of the acquiring and acquired firm.
- The big advantage of establishing a green-field 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.
- Strategic alliances are co-operative agreements between actual or potential competitors.
- The advantages 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.
- The disadvantage of a strategic alliance is that the firm risks giving away technological know-how and market access to its alliance partner in return for very little.
- 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.
- 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.

6.8 Keywords

Alliance Termination: Alliance termination involves winding down the alliance, for instance when its objectives have been met or cannot be met, or when a partner adjusts priorities or re-allocated resources elsewhere.

International Strategy: Trying to create value by transferring core competencies to foreign markets where indigenous competitors lack those competencies.

Joint Venture: A joint venture is an entity formed between two or more parties to undertake economic activity together.

Merger: Merger is a tool used by companies for the purpose of expanding their operations often aiming at an increase of their long-term profitability.

Multipoint Strategy: Emphasizing the need to be responsive to the unique conditions prevailing in different national markets.

Strategic Alliance: Strategic alliances are agreements between companies (partners) to reach objectives of a common interest.

Notes

6.9 Review Questions

1. What kinds of companies stand to gain the most from entering into strategic alliances with potential competitors? Why?
2. 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?
3. Whose interests should be the paramount concern of government trade policy (the interests of producers, business and their employees) or those of consumers?
4. Discuss the merits and demerits of the following strategies to enter international business: (i) Licensing, (ii) Strategic Alliance, and (iii) Joint Venture.
5. A small Canadian firm that has developed some valuable new medical products using its unique biotechnology know-how is trying to decide how best to serve the European Community market. Its choices are:

   (a) Manufacture the product at home and let foreign sales agents handle marketing.

   (b) Manufacture the products at home and set up a wholly owned subsidiary in Europe to handle marketing.

   (c) Enter into a strategic alliance with a large European pharmaceutical firm. The product would be manufactured in Europe by the 50/50 joint venture and marketed by the European firm.

   The cost of investment in manufacturing facilities will be a major one for the Canadian firm, but is not outside its reach. If these are the firm's only options, which one would you advise it to choose? Why?
6. What do you mean by strategic alliance? Also explain the various benefits of strategic alliance.
7. Describe the various goals of strategic alliance.
8. What do you mean by merger and acquisition? Give some example of merger and acquisition.
9. Describe the various disadvantages of strategic alliance.
10. What are the advantages and disadvantages of foreign direct investments?

Answers: Self Assessment

1. Experience curve, location economies
2. Turnkey
3. Core competencies
4. Tariff
5. Licensing
6. Technological know-how; management know-how;
7. Management know-how
8. True
9. True
10. False

Notes

11. False
12. Contractual arrangement
13. Contract negotiations
14. Joint venture
15. Merger

6.10 Further Readings

Books

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Unit 7: Foreign Direct Investment

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Objectives

After studying this unit, you should be able to:

- Discuss the importance of direct investments specially when, for example, a company builds a manufacturing plant in another country
- Know how to evaluate foreign direct investments, including the discount rate and tax rate to employ

Introduction

Through Foreign Direct Investment a firm invests directly in facilities to produce and/or market a product in a foreign country. For example, in the early 1980's Honda, a Japanese automobile company, built an assembly plant in Ohio and began to produce cars for the North American market. These cars were substitutes for imports from Japan. Once a firm undertakes FDI, it becomes a Multinational Enterprise (The meaning of Multinational being "more than one country").

Notes

FDI takes on two main forms; the first is a green field investment, which involves the establishment of a wholly new operation in a foreign country. The second involves acquiring or merging with an existing firm in a foreign country. Acquisition can be a minority (where the foreign firm takes a 10 percent to 49 percent interest in the company's Share Capital and voting rights), or majority (foreign interest of 10 percent to 99 percent) or full outright stake (foreign interest of 100 percent).

There is an important distinction between FDI and Foreign Portfolio Investment (FPI). Foreign portfolio investment is investment by individuals, firms or public bodies (e.g. National and local Govts) in foreign financial instruments, (e.g. Government bonds, foreign stocks). FDI does not involve taking a significant equity stake in a foreign business entity. FPI is determined by different facts than FDI. FPI provides great opportunities for business and individuals to build a truly diversified portfolio of international investments in financial assets, which lowers risk.

Notes FDI takes on two main forms; the first is a green field investment, which involves the establishment of a wholly new operation in a foreign country. The second involves acquiring or merging with an existing firm in a foreign country.

7.1 Overview of Foreign Direct Investment

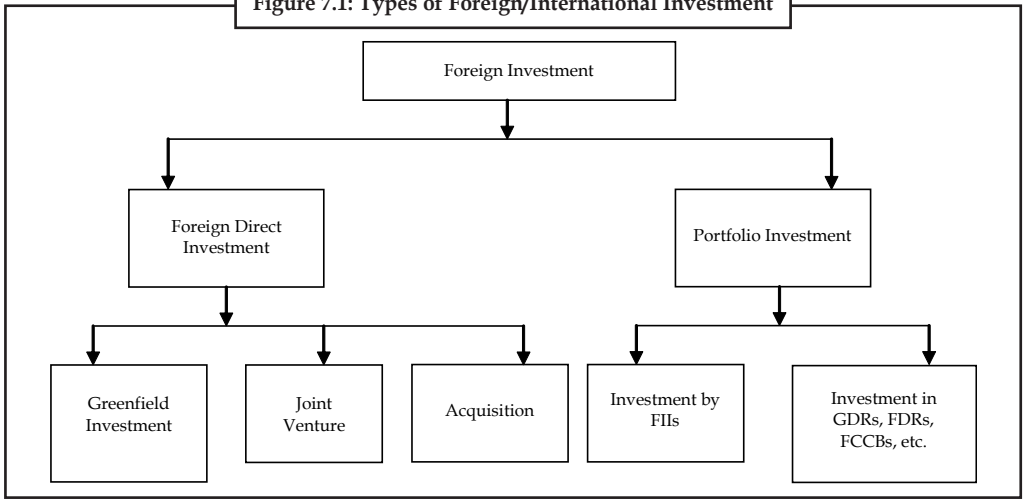
FDI means investment in a foreign country where the investor retains control over the investment. FDI implies that the investor exerts a significant degree of influence on the management of the enterprise in other country. It normally takes the form of starting a subsidiary, acquiring a stake in the existing firm or starting a joint venture in the foreign country.

Since FDIs cannot be easily liquidated, these are governed by long-term considerations. So the FDI decisions are affected by the following factors:

1. Political stability,
2. Government policy,
3. State of economic development,
4. Industrial prospects, etc.

The differences between FDIs and FPI are shown in figure 7.1.

Figure 7.1: Types of Foreign/International Investment



Notes

Foreign Direct Investment in the World Economy

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 accumulation of foreign owned assets at a given time. We also talk of outflows of FDI meaning the flow of FDI out of the country and inflows of FDI, meaning the flow of FDI into a country.

The past 20 years have seen a marked increase in both the flow and stock of FDI in the world economy. The average outflow of FDI is increased from about $25 billion in 1975 to a record of $1.3 trillion in 2000. The flow of FDI not only accelerated over this last quarter, country load is also accelerated faster than the growth in world trade. For example, between 1990 and 2000, the flow of FDI for all countries increased about five fold, while world trade grew by some 82 percent and world outflow by 23 percent. As a result of strong FDI flow, by 2000 the global stock of FDI exceeded $5.7 trillion. In total, 63,000 parent companies had 6,90,000 affiliates in foreign markets that effectively produced an estimated $14 trillion in global sales, nearly twice as high as the value of global exports.

Did u know? The past 20 years have seen an increase of more than 1000% in flow and stock of FDI in world economy.

FDI is growing more rapidly than world trade and world output for several reasons:

1. Fear of protectionist pressure despite the general decline in trade barriers, e.g, much of the Japanese automobile companies' investments in the United States during the 1980's and early 1990's were driven towards reduction of exports from Japan, thereby removing trade tensions between nations.
2. Dramatic political and economic changes that have been occurring in many of the world's developing nations, the general shift towards democratic political institutions and for market economies has encouraged FDI Economic growth, economic deregulation, privatization programs that are open to foreign investors and removal of many restrictions on FDI have made Asia, Eastern Europe and Latin America more attractive to foreign investors.
3. Increase in the amount of bilateral investment treaties designed to protect and promote investment between two countries, has been reflected in the decrease to facilitate FDI.
4. The globalization of the world economy is also having a great impact on the volume of FDI.
5. Many firms believe, it is important to have production facilities base close to the major customers. This too is creating pressures for greater FDI.

7.2 Types of FDI

7.2.1 Horizontal FDI

Horizontal FDI is the investment in the same industry abroad as the firm operates at home. Other things being equal, FDI is expensive because the 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 another culture where the "rules of the game" may be very different. When a firm exports, it need not bear the costs of FDI, and the risks associated with selling abroad can be reduced by using a native sales agent. Similarly, when a firm licenses its know-how, it need not bear the costs or risks of FDI. Firms prefer FDI over either

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exporting or licensing because of the following factors that alter the relative attractiveness of exporting, licensing, and FDI:

1. Transportation costs,
2. Market imperfections,
3. Following competitors,
4. Strategic behaviour, and
5. Location advantages.

Transportation Costs

When transportation costs are added to production costs, it becomes unprofitable to ship some products a long distance specially products that have a low value-to weight ratio and can be produced in almost any location (e.g. cement, soft drinks etc). For such products, relative to either FDI or licensing, the attractiveness of exporting decreases. Thus transportation costs alone can explain why Cemex, the largest cement manufacturer of Mexico has undertaken FDI rather than exporting. For products with a high value-to-weight ratio, transport costs are normally a very minor component of total landed cost (e.g. electronic components, personal computers, medical equipment, computer software etc.). In such cases, transportation costs have little impact on the relative attractiveness of exporting, licensing, and FDI.

Caution Products having low value-weigh ratio acquire higher transportation cost resulting in unprofitable transactions.

Market Imperfections

Market imperfections are factors that restrain markets from working perfectly. In the international business literature, the marketing imperfection approach to FDI is typically referred to as Internationalization theory. With reference to horizontal FDI, market imperfections arise in two circumstances: when there are impediments to the sale of know-how (licensing is a mechanism for selling know-how). Impediments to the free-flow of products between nations decrease the probability of exporting, relative to FDI and licensing. Impediments to the sale of know-how increase the profitability of FDI relative to licensing. Thus, the market imperfections explanation predicts that FDI will be preferred whenever there are impediments that make both exporting and the sale of know how difficult and/or expensive.

Impediments to Exporting: Governments are the main source of impediments to the free flow of products between nations. By placing tariffs on imported goods, government increases the cost of exporting relative to FDI and licensing. Similarly, by limiting imports through the imposition of quotas, governments increase the attractiveness of FDI and licensing. For example, the flow of FDI by Japanese auto companies in the United States during the 1980s was partly driven by protectionists threats from Congress and by quotas on the import of Japanese cars. For Japanese auto companies, these factors have decreased the profitability of exporting and increased the profitability of FDI.

Impediments to sale of know-how: According to economic theory, there are three reasons that the market does no always work well as a mechanism for selling know-how, or why licensing is not attractive as it initially appears. First, licensing may result in a firm's giving away its' know-how to a potential foreign competitor. Second, licensing does not give a firm tight control over production, marketing, and in a foreign country that may be required to profitably exploit its advantage in know-how. With licensing, control over production, marketing and strategy

is 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.

Example: A firm might want its foreign subsidiary to price and market very aggressively, but the licensee may be unable to do this.

Third, a firm's know-how may not be amenable to licensing. This is particularly true of management and marketing know-how, where the kinds of skills required are difficult to codify and cannot be written down in a simple licensing contract. They are organization wide and have been developed over years. They are not embodied in any one individual, but instead are widely dispersed throughout the company.

Product Life Cycle

The product life cycle holds that every product or line of business proceeds through four phases: development, growth, maturity and decline. During the first two stages, sales growth is rapid and entry is easy. As individual firms gain experience and as growth slows in the last two stages, entry becomes difficult because of cost advantages of incumbents. In the decline phase of the product line (as other product substitutes emerge) sales and prices decline, firms which have not achieved a favourable position on the experience curve become unprofitable and either merge or exit from the industry.

Strategic Behaviour

Another theory to explain FDI is based on the idea that FDI flows are a reflection of strategic rivalry between firms in the global market place. An early variant of this argument was expounded by F. T. Knickerbocker, who looked at the relationship between FDI and rivalry in oligopolistic industries. An oligopoly is an industry composed of a limited number of large firms (e.g. an industry in which four firms control 80 per cent of a domestic market may 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.

Knickerbocker's theory can be extended to embrace the concept of multipoint competition. Multipoint competition arises when two or more enterprises encounter 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, e.g., compete against each other around the world. If Kodak enters a particular foreign market, Fuji will not be far behind.

Location Advantages

The British economist John Dunning has argued that location specific advantage can help explain the nature and direction of FDI. By location-specific advantages, Dunning means the advantages that arise from using resource endowments or assets that are tied to a particular foreign location and that a firm finds value to combine with its own unique assets (such as the firm's technological, marketing, or management know-how). Dunning accepts the internalization argument that market failures make it difficult for a firm to license its own unique assets (know-how). Therefore he argues 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 these foreign assets or resource endowments are located.

Example: An obvious example of Dunning's arguments is natural resources, such as oil and other minerals, which are specific to certain locations. Dunning suggests that affirm must

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undertake FDI to exploit such foreign resources. This explains the FDI undertaken by many of the world's oil companies, which have to invest where oil is located to combine their technological and managerial knowledge with this valuable location-specific resource. Another example is valuable human resources, such as low-cost highly skilled labour. The cost and skill of labour varies from country to country. Since labour is not internationally mobile, according to Dunning it makes sense for a firm to locate production facilities where the cost and skills of local labour are most suited to its particular production process.

7.2.2 Vertical FDI

Vertical FDI takes two forms, there is backward vertical FDI into an industry abroad that provides inputs for a firm's domestic production processes. Historically, most backward vertical FDI has been in extractive industries

Example: Oil extraction, bauxite mining, tin mining, and copper mining.

The objective has been to provide inputs into a firm's downstream operations.

Example: Oil refining, aluminium smelting and fabrication, tin smelting and fabrication.

Firms such as Royal Dutch/Shell, British Petroleum (BP), RTZ, and Consolidated Gold Field are among the classic examples of such vertically integrated multinationals.

A second form of vertical FDI is forward vertical FDI in which an industry abroad sells the outputs of a firm's domestic production processes. Forward vertical FDI is less common than backward vertical FDI.

Example: Volkswagen entered the US market, it acquired a large number of dealers rather than distribute its cars through independent US dealers.

The question may arise that why firms go to all the trouble and expense of setting up operations in a foreign country. There are two basic answers–the first is a strategic behaviour argument and the second draws on the market imperfections approach.

Did u know? Vertical FDI has two forms, backward and forward.

Strategic Behaviour Argument

According to economic theory, by vertically integrating backward to gain control over the source of raw material, a firm can raise entry barriers and shut new competitors out of an industry. Such strategic behaviour involves vertical FDI if the raw material is found abroad.

Another stand of the strategic behaviour explanation of vertical FDI sees such investment not as an attempt to build entry barriers, but as an attempt to circumvent the barriers established by firms already doing business in a country. This may explain Volkswagen's decision to establish its own dealer network when it entered the North American auto market.

Market Imperfections Approach

The market imperfections approach offers two explanations for vertical FDI. The first explanation revolves around the idea that there are impediments to the sale of know-how through the market mechanism. The second explanation is based on the idea that investments in specialized assets expose the investing firm to hazards that can be reduced only through vertical FDI.

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Impediments to the Sale of Know-how

Oil refining companies such as British Petroleum and Royal Dutch/Shell pursued backward vertical FDI to supply their British and Dutch oil refining facilities with crude oil, in the early decades of this century when neither Great Britain nor the Netherlands had domestic oil supplies.

Generalizing from this example, the prediction is that backward vertical FDI will occur when a firm has the knowledge and the ability to extract raw materials in another country and there is no efficient producer in that country that can supply raw materials to the firm.

Investments in Specialized Assets

In this context, a specialized asset is an asset designed to perform a specific task and whose value is significantly reduced in its next-best use. Consider the case of an aluminium refinery which is designed to refine bauxite ore and produce aluminium. Bauxite ores vary in context and chemical composition from deposit to deposit. Each type of ore requires a different type of refinery. Running one type of bauxite through a refinery designed for another type increases production costs by 20 to 100 per cent. Thus the value of an investment in an aluminium refinery depends on the availability of the desired kind of bauxite ore.

The implications of the theories of horizontal and vertical FDI for business practice are relatively straight forward. First, the location-specific advantages argument associated with John Dunning helps explain the direction of FDI, both with regard to horizontal and vertical FDI. From both an explanatory and a business perspective, the most useful theory is the market imperfections approach. With regard to horizontal FDI, this approach identifies with some precision how the relatives rates of return associated with horizontal FDI, exporting and licensing vary with circumstances. The theory suggests that exporting is preferable to licensing and horizontal FDI is more costly and more risky as long as transport costs are minor and tariff barriers are trivial. As transport cost and/or tariff barriers increase, exporting becomes unprofitable, and the choice is between horizontal FDI and licensing. Since horizontal FDI is more costly and more risky than licensing, other things being equal, the theory argues that licensing is preferable to horizontal FDI. Although licensing may work, it is not an attractive option when one or more of the following conditions exist:

1. the firm has valuable know-how that cannot be adequately protected by a licensing contract
2. the firm needs tight control over a foreign entity to maximize its market share and earnings in that country, and
3. a firm's skills and know-how are not amenable to licensing.

Self Assessment

Fill in the blanks:

1. The market ..... approach offers two explanations for vertical FDI.
2. According to ..... theory, by vertically integrating backward to gain control over the source of raw material, a firm can raise entry barriers and shut new competitors out of an industry.
3. ..... FDI takes two forms, there is backward vertical FDI into an industry abroad that provides inputs for a firm's domestic production processes.
4. The British economist ..... has argued that location specific advantage can help explain the nature and direction of FDI.
5. Market ..... are factors that restrain markets from working perfectly.

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7.2.3 Implications of FDI

Firms for which licensing is not a good option tend to be clustered in three types of industries:

1. High-technology industries where protecting firm-specific expertise is of paramount importance and licensing is hazardous.
2. Global oligopolies, where 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 has done with Fuji).
3. Industries where intense cost pressures require that multinational firms maintain tight control over foreign operations (so they can disperse manufacturing to locations around the globe where factor costs are most favourable to minimize costs).

The majority of the limited evidence seems to support these conjectures. 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, and/or the skills of its managers, and 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. Licensing tends to be more common (and more profitable) in fragmented, low-technology industries in which globally dispersed manufacturing is not an option. Licensing is also easier if the knowledge to be transferred is relatively easy to codify. A good example of an industry where these conditions seem to exist 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 as 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:

1. Like many services, fast food cannot be exported,
2. Franchising economizes the costs and risks associated with opening foreign markets,
3. Unlike technological, brand names are easy to protect using a contract,
4. There is no compelling reason for McDonald's to have tight control over franchisees, and
5. 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).

It may be noted that McDonald's does undertake some FDI to establish "master franchisors" in each country in which it does business. These master franchisors are normally joint ventures with local companies and their task is to manage McDonald's franchisees within a particular country.

In contrast to the market imperfections approach, the product life-cycle theory and Knickerbocker's theory of horizontal FDI tend to be less useful from a business perspective. These two theories are descriptive rather than analytical. They do a good job of describing the historical pattern of FDI, but they do a relatively poor job of identifying the factors that influence the relative profitability of FDI, licensing and exporting. The issue of licensing as an alternative to FDI is ignored by both these theories.

Finally, with regard to vertical FDI, both the market imperfections approach and the strategic behaviour approach have some useful implications for business practice. The strategic behaviour

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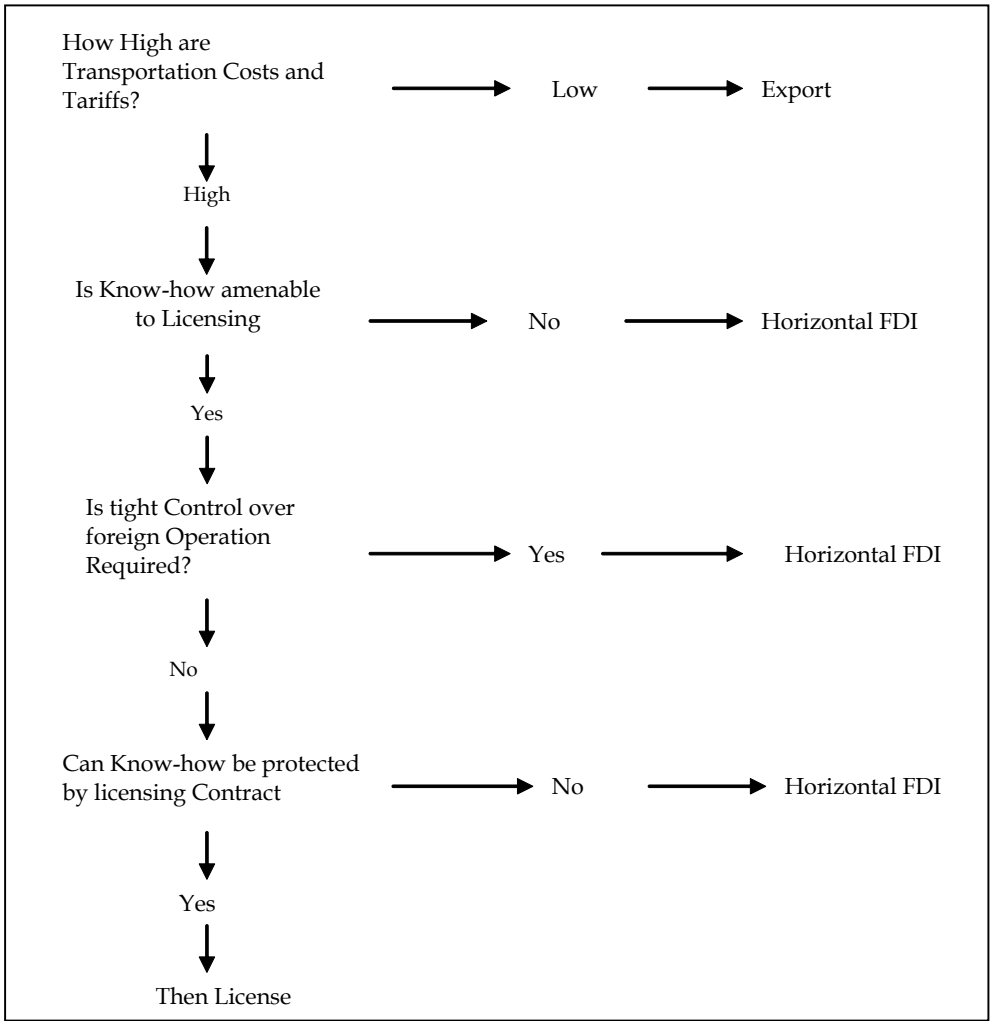
approach points out that vertical FDI may be a way of building barriers to entry into an industry. The strength of the market imperfections approach is that it points the conditions under which vertical FDI might be preferable to the alternatives. Most importantly, the market imperfections approach points to the importance of investments in specialized assets and imperfections in the market for know-how as factors that increase the relative attractiveness of vertical FDI.

Figure 7.2: A Decision Framework



Self Assessment

Choose the appropriate answer:

6. Consider the case of IBM and Mexico. IBM was in a fairly strong bargaining position, primarily because Mexico was suffering freedom a flight of capital out of the country during 1985 and 1986, which made the government eager to attract new foreign investment. But IBM's bargaining power was moderated somewhat by the following

   (a) Size of the proposed investment was unlikely to have more than a marginal impact on the Mexican economy.

   (b) IBM was looking for a low-labour-cost most desirable location close to the United States.

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(c) Before others move in IBM felt it needed to move quickly to establish its own low-cost production facilities.

(d) (a) and (b)

(e) (a), (b) and (c)

7.3 Reasons for FDI

There are strong reasons why MNCs are welcomed to invest in foreign countries. Some of the prominent reasons are explained below:

1. ***To fill the gap between available domestic resources and the desired level of resources:*** Traditionally, foreign investment is seen as a way of filling the gap between the domestically available supplies of savings, foreign exchange, government revenue and human capital skills and the desired level of these resources necessary to achieve growth and development targets. If domestic savings are inadequate to generate enough investments, foreign capital is expected to fill the gap between targeted or desired investment and locally mobilized savings.

   Often, the foreign exchange earnings generated from exports and foreign aid fall short of the targeted requirements. This is typically called trade deficit or gap. An inflow of FDI can not only alleviate part or all of the deficit on the balance of payments current account, but can also function to remove that deficit over time, if the MNCs can generate a net positive inflow of export earnings. There can be a gap between targeted government tax revenues and locally raised taxes. By taxing the MNC's profits and participating financially in their local operations, governments of developing countries are expected to be able to mobilize public financial resources for development projects.

2. ***To fill the gap in management, entrepreneurship and technology:*** There is also a gap in management, entrepreneurship, technology and skill which is presumed to be partly or wholly filled by the local operations of MNCs. Not only do multinationals provide financial resources and factories to poor countries, but they also supply a 'package' of needed resources, including managerial experience, entrepreneurial abilities, and technological skills that can then be transferred to their local counterparts by means of training programmes and by the process of 'learning by doing'. In addition, MNCs educate local managers about how to establish contacts with foreign banks, locate alternative sources of supply, diversify market outlets and become better acquainted with international marketing practices. Besides, MNCs bring with them, the most sophisticated technological knowledge about production processes along with modern machinery and equipment to the capital-starved developing countries. It is assumed that a part of this knowledge leaks out to the broader economy when engineers and managers leave to start their, own enterprises. Such transfers of knowledge, skills and technology are assumed to be both desirable and productive for the recipient nations.

3. ***Promotion of domestic investment:*** Factories set up by MNCs act as a nucleus of growth. An industrial enterprise established by a foreign company gives birth to several other enterprises which supply inputs to the parent company. It is not as if only a few surrounding firms are the beneficiaries; an entire industry may get boost. It is estimated that every dollar of FDI increases domestic investment by 80 per cent of the amount of FDI.

4. ***Promotion of healthy competition in host countries:*** FDI can generate healthy competition in the recipient countries. When FDI assumes the form of greenfield projects, the result is the creation of new enterprises, adding to the number of players in the market. By implication, this can increase the level of competition in the host country. Intense competition enhances consumer choice, tends to bring down prices and boosts economic welfare of the consumers. Increased competition tends to stimulate capital investments by firms in plant, equipment

and R&D, in order to gain competitive advantage over their rivals. All these tend to result, in the long run, in increased productivity, innovations and greater economic growth.

5. ***To take benefit of locational advantage:*** Too often, locational advantages attract FDI. The location-specific advantages, in particular, include natural resources such as oil and other minerals, which are, by nature, specific to certain locations. A firm must undertake FDI to exploit such endowments. This explains the FDI undertaken by many of the world's oil companies, which had to invest where oil was located. Another example is the valuable human resource, such as low-cost highly skilled labour force. The cost and skill of labour varies from country to country. One major benefit of locating plants in Mexico is the availability of highly skilled labour force that can be hired at fairly low wage rates. Additionally, manufacturing firms located in Mexico report high productivity growth rates and quality performance. France has been the target of much MNC activity. Daimler-Chrysler has recently built a new factory in France because of its faith in the workers' productivity and work ethics. Additionally, France's recent economic growth has impressed many MNCs.

Example: Hyundai, the automobile giant from South Korea, has chosen Chennai in India for its new car manufacturing plant. Skilled labour at low wages, location of auto parts manufacturers (such as Wheels India, Brakes India, Sundaram Fasteners, Sundaram Brakes, Bimetal Bearings, Tafe, and India Pistons in and around Chennai), guaranteed power supply, cheap land and proximity to sea port have attracted the plant to the capital city of Tamil Nadu. The argument that location-specific advantages attract FDI is propounded by the British economist John Dunning. Dunning believes that market imperfections make licensing and exporting difficult and thereby render FDI an obvious choice for globalization.

6. ***To reduce security risks:*** FDI often depends on a country's political attempts to reduce security risks. For example, Chinese state-owned petroleum companies have been investing abroad so as to minimize dependence on foreign companies for oil supplies. The move may also help China hold down prices on the petroleum it receives. There is one more political motive behind FDI. During the early 1980s, the US government instituted various incentives to increase the profitability of US investments in Caribbean countries that were unfriendly to Cuba's Castro regime. The US wanted to strengthen the economies of those friendly nations through the growth of the FDI and make it difficult for unfriendly leftist governments to gain control. But with the end of the Civil war, the US ended investment incentives in the Caribbean region, and much investment was diverted to Mexico because of NAFTA.

7. ***For economic growth in developing countries:*** Aid from international institutions and rich countries can be a temporary measure for poverty alleviation. Economic growth ushered in by increased investment can be a permanent solution. Jeffrey Sachs, Special Adviser to the then Secretary General, Kofi Annan, on the Millennium Development Goals, told a press briefing on Sept 22, 2004, "*Many of the poorest countries are simply being bypassed by globalization, and the promises of the rich countries are not being fulfilled. We need more globalization that reaches poor countries, and more successful globalization, not less. The kind of globalization that the poorest countries are feeling is brain drain. They are not seeing the inflow of foreign investment.*" Sachs added that FDI would be the strongest engine of growth in the developing world.

Given the limitations of domestic savings, many developing countries will have to rely on foreign investment to accelerate economic growth. It may be noted that china has been able to maintain a high GDP growth rate for a long time because of a high savings rate and huge inflow of FDI.

Notes FDI often depends on a country's political attempts to reduce security risks.

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Task Mention the current FDI limits of any country other than your native country.

7.4 Benefits of FDI

7.4.1 FDI Benefits to Host Countries

The four main benefits of FDI to host country are:

1. Resource-transfer effects,
2. Employment effects,
3. Balance-of-payments effect, and
4. Effect on competition and economic growth.

Resource-transfer Effects

FDI 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.

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 resources, or because of their reputation, large MNEs may find it easier to borrow money from capital markets that host-country firms would.

Technology can stimulate economic development and industrialization. It can take two forms, both are valuable. Technology can be incorporated in a production process or it can be incorporated in a product.

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 green-field developments. Beneficial spin-offs 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

The effects of FDI on employment are both direct and indirect. Direct efforts 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 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.

Example: When Toyota opened a new auto plant in France in 1997, estimates suggested the plant would create 2,000 direct jobs and perhaps another 2,000 jobs in support industries.

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Balance-of-Payments Effect

Given the concern about current account deficits, the balance-of-payments effects of FDI can be an important consideration for a host government. There are three potential balance-of-payments consequences of FDI. First, when an MNE establishes a foreign subsidiary, the capital account of the host country benefits from the initial capital inflow (A debit will be recorded in the capital account of the MNEs home country since capital is flowing out of the home country).

Second, if the FDI is a substitute for imports of goods or services, it can 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 United Kingdom, for example can be seen as substituting for imports from Japan.

A third potential benefit to the host country's balance-of-payments position arises when the MNE uses a foreign subsidiary to export goods and services to other countries.

Effect on Competition and Economic Growth

When FDI takes the form of a green-field 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 competition in a national market and thus consumer choice. In turn, this can increase 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.

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.

7.4.2 Benefits and Costs of FDI to Home Countries

Benefits of FDI to the Home Country

The benefits of FDI to the home country arise from three sources.

1. The capital account of the home country's balance-of-payments benefits from the inward flow of foreign earnings FDI can also benefit the current account of the home country's balance of payments if the foreign subsidiary created demands for home country exports of capital equipment, intermediate goods, complementary products, and the like.
2. 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 of capital equipment, intermediate goods, complementary products, and the like. 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.
3. Benefits arise when the home-country MNE learns valuable skills from its exposure to foreign markets that can be transferred back to 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 products and process techniques. These resources can then be transferred back to the home country, contributing to the home country's economic growth rate.

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Costs of FDI to the Home Country

Against these benefits there are 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 capital account of the balance of the 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.

With regard to employment effects, the most serious concerns arise when FDI is seen as a substitute for domestic production.

Self Assessment

Fill in the blanks:

7. The four main benefits of FDI to host country are ....., ..., ... and ..... .
8. FDI can make a positive contribution to a host economy by supplying ....., ..., and ..... .

7.5 Trends in FDI

Indian has been attracting foreign direct investment for a long period. The sectors like telecommunication, construction activities and computer software and hardware have been the major sectors for FDI inflows in India.

According to AT Kearney report India sits in 3rd place on the FDI Confidence Index globally. European and North American investors place it 3rd, while Asia-Pacific investors' rank it 4th. India is the top location for non-financial services investment, and also scores highly in heavy industries, light industries and financial services. Even during economic crisis looming largely on other economies, FDI inflows to India soared from US $ 25.1 billion in 2007 to US $ 41.6 billion in 2008.

Multinationals are managing to counter FDI restrictions and supply chain challenges at the most possible way showing path to others who are hesitant to enter into Indian market.

Example: Wal-Mart has taken steps to develop supply chains, procure 30-35 per cent local produce, making changes to its stock policy by reducing inventories etc. Similarly, Auto majors are pumping money in the sector. Ford planned to invest US $ 500 mn in its Chennai plant, Nissan-Renault planning to manufacture ultra-low-cost car with its local partner Bajaj Auto, French tyre maker Michelin's to invest US $ 874 mn in its first Indian manufacturing facility. All these developments are helping in getting FDI inflows into the country.

The measures introduced by the government to liberalize provisions relating to FDI in 1991 lure investors from every corner of the world. As a result FDI inflows during 1991–92 to March 2010 in India increased manifold as compared to during mid-1948 to March 1990. As per the fact sheet on FDI, there was ₹ 6,303.36 billion FDI equity inflows between the period of August 1991 to January 2011.

The FDI inflows in India during mid-1948 were ₹ 2.56 billion. It is almost double in March 1964 and increases further to ₹ 9.16 billion. India received a cumulative FDI inflow of ₹ 53.84 billion during mid-1948 to March 1990 as compared to ₹ 1,418.64 billion during August 1991 to March 2010.

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An annual FDI inflow indicates that FDI went up from around negligible amounts in 1991–92 to around US $ 9 billion in 2006–07. It then hiked to around US $ 22 billion in 2007–08, rising to around US $ 37 billion by 2009–10.

Caselet

Take a Stand

Many multinational companies are now following a very similar strategy of moving their manufacturing facilities out of large, industrialized countries like the United States, Germany, and the United Kingdom, and relocating them to countries in which labour is much cheaper, such as mainland China. This is, however, very controversial given slow economic growth and growing unemployment in the industrial countries.

According to most theories of international trade, once the technology of an industry has matured and countries have deregulated their economies sufficiently to allow capital to flow across borders relatively freely, companies in industries that can use lower-cost labour – assuming that sufficient skills are available – should move their manufacturing to those lower-labour-cost countries. The competitive strategy argument is that if one company does not, and another does, the first will be unable to compete in the future.

For Discussion

Multinationals should not continue to move their manufacturing out of industrial countries. They are contributing to rising unemployment, undermining the economies of countries like the United States and Germany, and are simply serving as devices to exploit cheap labour in developing countries.

Multinationals must continue to take whatever actions are necessary, including moving manufacturing to lower-cost countries, to remain competitive. The people, the workers, and the economies of countries like the United States and Germany cannot artificially protect their economies from global competition; it would only serve to create countries of lesser and lesser competitiveness in the coming years.

Source: Michael R. Czinkota, Ilkka A. Ronkainen, Michael H. Moffett, "*International Business*", Cengage Learning, p.206-207.

Even if we examine quarterly figures, we find that FDI flows that rose from US$6.9 billion in the second quarter of 2009 to a peak of US$8.2 billion in the third quarter of that year, have since stayed in the 5–6 billion range for all but one quarter, namely January-March 2011. In fact, if we consider the 16 quarters ending Jan-March 2011, there have been only two in which FDI inflows stood at between US$6–7 billion and four when it exceeded US$7 billion.

It is now clear that FDI was related to the recessionary conditions in the western economies. The recent flattening of monthly FDI flows is a sign more of recovery in the western economies than any loss of long term interest in the Indian economy. The monthly figure only shows that the incremental FDI is going back to the pre-recession years rather than indicating decline of FDI into India.

Did u know? In India, there are only some fields in which FDI is allowed.

In fact when foreign direct investment into India had "tumbled 32 per cent to just US$3.4 billion", as mentioned in financial times during January to March 2011 that it emerged that net FDI flows in the month of April alone amounted to US$3.1 billion.

Notes

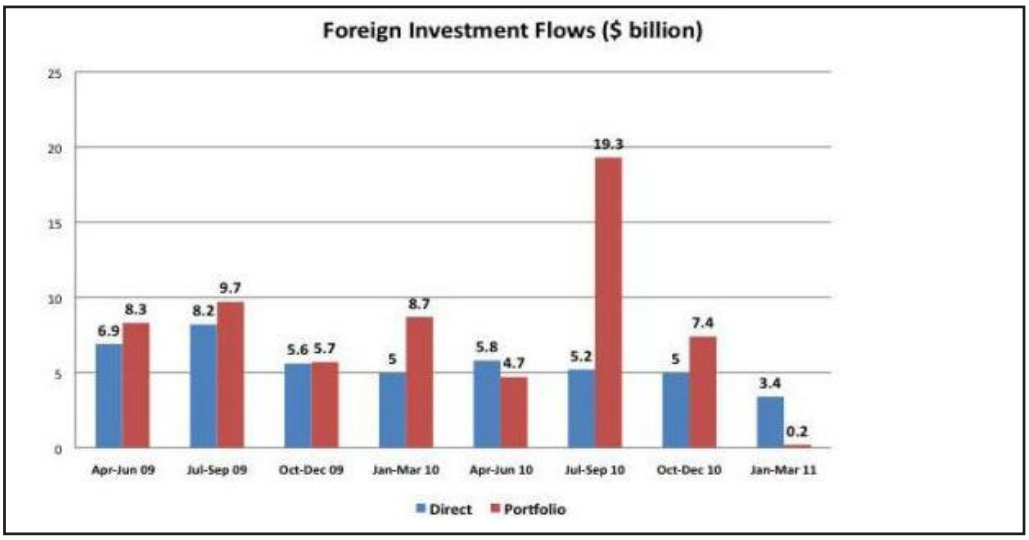
Table 7.1: FDI Flow in India

Years	FDI inflows in India (In crores)
1991-92	409
1992-93	1094
1993-94	2018
1994-95	4312
1995-96	6916
1996-97	9654
1997-98	13548
1998-99	12343
1999-00	10311
2000-01	10368
2001-02	18486
2002-03	13711
2003-04	11789
2004-05	14653
2005-06	24613
2006-07	70630
2007-08	98664
2008-09	123025

Source: Various issues of STA Bulletin

Also, FDI is all about long term investment. Companies have already invested in to India and are unlikely to move elsewhere. Unless any dramatic negative changes in policy, FDI will continue to inch upwards.

Recent trends have also shown that FDI inflow changes are mainly due to portfolio investment, which displayed a degree of volatility.



Source of FDI: The list of investing countries to India reached to maximum number of 120 in 2008 as compared to 15 in 1991. Although, India is receiving FDI inflows from a number of sources but large percentage of FDI inflows is vested with few major countries.

Notes

Mauritius is the major investing country in India during 1991–2008. Nearly 40 per cent of FDI inflows came from Mauritius alone. The other major investing countries are USA, Singapore, UK, Netherlands, Japan, Germany, Cypress, France and Switzerland. An analysis of last eighteen years of FDI inflows in the country shows that nearly 66per cent of FDI inflows came from only five countries viz. Mauritius, USA, Singapore, UK, and Netherlands.

Mauritius and United states are the two major countries holding first and the second position in the investor's list of FDI in India. While comparing the investment made by both countries, one interesting fact comes up which shows that there is huge difference in the volume of FDI received from Mauritius and the US. It is found that FDI inflows from Mauritius are more than double from that of US.

Top 10 FDI investing countries in India are Mauritius, Singapore, United States, UK, Netherlands, Japan, Cyprus, Germany, France and UAE.

Table 7.2: Share of Top Investing Countries FDI Equity Inflows

Amount Rupees in crores (US$ in million)

Ranks	Country	2009-10 (April-March)	2010-11 (April-March)	2011-12 (for April 2011)	Cumulative Inflows (April '00 - April '11)	%age to total Inflows (in terms of US $)
1.	MAURITIUS	49,633 (10,376)	31,855 (6,987)	4,332 (976)	247,092 (55,203)	42 %
2.	SINGAPORE	11,295 (2,379)	7,730 (1,705)	5,214 (1,175)	58,090 (13,070)	10 %
3.	U.S.A.	9,230 (1,943)	5,353 (1,170)	356 (80)	42,898 (9,529)	7 %
4.	U.K.	3,094 (657)	3,434 (755)	19 (4)	29,451 (6,643)	5 %
5.	NETHERLANDS	4,283 (899)	5,501 (1,213)	172 (39)	25,799 (5,739)	4 %
6.	JAPAN	5,670 (1,183)	7,063 (1,562)	1,043 (235)	25,001 (5,511)	4 %
7.	CYPRUS	7,728 (1,627)	4,171 (913)	754 (170)	22,702 (4,982)	4 %
8.	GERMANY	2,980 (626)	908 (200)	231 (52)	13,607 (3,051)	2 %
9	FRANCE	1,437 (303)	3,349 (734)	977 (220)	11,244 (2,484)	2 %
10.	U.A.E.	3,017 (629)	1,569 (341)	91 (21)	8,683 (1,910)	1 %
TOTAL FDI INFLOWS *		123,120 (25,834)	88,520 (19,427)	13,846 (3,121)	594,569 (132,837)	-

Note: (i) **Includes inflows under NRI Schemes of RBI.*
(ii) *Cumulative country-wise FDI equity inflows (from April 2000 to April 2011) – Annex-'A'.*
(iii) *%age worked out in US$ terms & FDI inflows received through FIPB/SIA+ RBI's Automatic Route+ acquisition of existing shares only.*

Source: http://www.indiabiznews.com/sites/default/files/fdi3.png

FDI-Sectoral analysis: FDI inflows are welcomed currently in 63 sectors as compared to 16 sectors in 1991. The sectors receiving the largest share of FDI inflows up to 2010 were the service sector and computer software and hardware sectors, each accounting for 22.14 per cent and 9.48 per cent respectively. There were followed by the telecom, real estate, construction and automobile sectors. The top sectors attracting FDI into India via M&A activity were manufacturing, information; and professional, scientific and technical services.

1. Infrastructure sector received 28.62% of total FDI inflows from 1991–2008
2. Services sector received 19.34% of total FDI inflows from 1991–2008.
3. Trading sector received 1.67% of total FDI inflows from 1991–2008.

Notes

4. Consultancy Sector received 1.14% of total inflows from 2000–2008
5. Education sector received US $308.28 million of FDI inflows from 2004–2008.
6. Housing and Real Estate Sector accounts for 5.78% of total FDI inflows during 2000–2008.
7. Construction Activities Sector received 6.15% of the total inflows during 2000 to Dec. 2008.
8. Automobile Industry received US $3.2 billion of total FDI inflows to the country during 2000 to 2008.
9. Computer Software and Hardware sector received US $8.9 billion of total FDI inflows during 2000 to Dec. 2007.
10. Telecommunications Sector received an inflow of US $8.2 billion during 1991 to 2008.

Table 7.3: FDI Inflow in Different Sectors

Amount inRs. crores (US$ in million)

Ranks	Sector	2009-10 (April-March)	2010-11 (April-March)	2011-12 (for April 2011)	Cumulative Inflows (April '00 - April '11)	% age to total Inflows (In terms of US$)
1.	SERVICES SECTOR (financial & non-financial)	20,776 (4,353)	15,539 (3,403)	2,922 (658)	123,706 (27,668)	21 %
2.	COMPUTER SOFTWARE & HARDWARE	4,351 (919)	3,571 (784)	425 (96)	48,135 (10,821)	8 %
3.	TELECOMMUNICATIONS (radio paging, cellular mobile, basic telephone services)	12,338 (2,554)	7,546 (1,665)	205 (46)	48,313 (10,611)	8 %
4.	HOUSING & REAL ESTATE	13,586 (2,844)	5,149 (1,127)	167 (38)	43,288 (9,655)	7 %
5.	CONSTRUCTION ACTIVITIES (including roads & highways)	13,516 (2,862)	5,077 (1,125)	1,381 (311)	42,160 (9,491)	7 %
6.	AUTOMOBILE INDUSTRY	5,754 (1,208)	6,008 (1,331)	1,182 (266)	28,037 (6,199)	5 %
7.	POWER	6,908 (1,437)	5,709 (1,252)	1,136 (256)	27,848 (6,156)	5 %
8.	METALLURGICAL INDUSTRIES	1,935 (407)	5,055 (1,105)	229 (52)	18,724 (4,286)	3 %
9.	PETROLEUM & NATURAL GAS	1,328 (272)	2,621 (574)	28 (6)	13,763 (3,159)	2 %
10.	CHEMICALS (other than fertilizers)	1,707 (362)	1,810 (398)	152 (34)	13,234 (2,927)	2 %

Source: http://www.indiabiznews.com/sites/default/files/fdi4.png

Notes

Table 7.4: Sector Specific FDI Policy

Sr. No.	Sector/Activity	FDI cap/Equity	Entry/Route
1.	Hotel & Tourism	100%	Automatic
2.	NBFC	49%	Automatic
3.	Insurance	26%	Automatic
4.	***Telecommunication:*** cellular, value added services ISPs with gateways, radio-paging Electronic Mail & Voice Mail	 49% 74% 100%	Automatic Above 49% need Govt. licence
5.	***Trading companies:*** primarily export activities bulk imports, cash and carry wholesale trading	 51% 100%	 Automatic Automatic
6.	Power(other than atomic reactor power plants)	100%	Automatic
7.	Drugs & Pharmaceuticals	100%	Automatic
8.	Roads, Highways, Ports and Harbors	100%	Automatic
9.	Pollution Control and Management	100%	Automatic
10	Call Centers	100%	Automatic
11.	BPO	100%	Automatic
12.	***For NRI's and OCB's:*** i. 34 High Priority Industry Groups ii. Export Trading Companies iii. Hotels and Tourism-related Projects iv. Hospitals, Diagnostic	100%	Automatic

Source: http://www.indiabiznews.com/sites/default/files/fdi5.png

7.6 Foreign Direct Investment in India

India has retained its position as the second most-preferred global location for foreign investment in 2008 and will continue to do so till 2010, lagging only behind China, the United Nations Conference on Trade and Development (UNCTAD) has said in World Investment Report 2008.

In the schema of classification of capital flows based on duration, FDI has been the most attractive type of capital flows for emerging market economies because of its lasting nature and also because it is considered a vehicle for transformation of the domestic production process through bridging the technological gap. Concerted efforts towards attracting FDI through an emphasis on policies of promoting non-debt creating capital inflows during the reform period did not yield results on the expected lines initially.

FDI in India has increased over the years due to the efforts that have been made by the Indian government. The increased flow of FDI in India has given a major boost to the country's economy and so measures must be taken in order to ensure that the flow of FDI in India continues to grow.

The total amount of FDI in India came to around US$ 42.3 billion in 2001, in 2002 this figure stood at US$ 54.1 billion, in 2003 this figure came to US$ 75.4 billion, and in 2004 this figure increased to US$ 113 billion.

With reform in policies, better infrastructure and a more vibrant financial sector, FDI inflows into India accelerated in 2006-07. On a gross basis, FDI inflows into India, after rising to a level of US$ 6.2 billion in 2001-02, fell to US$ 4.5 billion in 2003-04. After a recovery, the proportion has risen to reach US$ 23.0 billion in 2006-07. The trend continued in the current financial year with gross

Notes

FDI flows at US$ 11.2 billion in the first six months. FDI inflows continued to be preponderantly of the equity variety, broad-based and spread across a range of economic activities like financial services, manufacturing, banking services, information technology services and construction.

From April 2000 to November 2007, Mauritius remained the predominant source country for FDI to India accounting for 44.24 per cent share of the cumulative total, followed by the United States (9.37 per cent), the United Kingdom (7.98 per cent) and the Netherlands (5.81 per cent). During April-November 2007, the position of Mauritius remained still prominent (42.77 per cent). While the shares of the United States (5.45 per cent), the United Kingdom (2.19 per cent) and the Netherlands (4.51 per cent) were lower, those of Japan (5.72 per cent) and Singapore (8.73 per cent) were higher.

Note The total amount of FDI in India came to around US$ 42.3 billion in 2001, in 2002 this figure stood at US$ 54.1 billion, in 2003 this figure came to US$ 75.4 billion, and in 2004 this figure increased to US$ 113 billion.

7.6.1 Sectoral Inflows of FDI in India

The major sectors of the Indian economy that have benefited from FDI in India are:

- Financial sector (banking and non-banking).
- Insurance
- Telecommunication
- Hospitality and tourism
- Pharmaceuticals
- Software and Information Technology.

Table 7.5: Sectors Attracting Highest FDI Equity Inflows

(*In ₹ crore*)

SECTOR	2005–06	2006–07	2007–08	2008–09 (April-July)	Cumulative (Apr.2000-July 2008)	% of total inflows*
Services (Financial & non-financial)	2399 (543)	21047 (4664)	26589 (6615)	6684 (1602)	62381 (14659)	20.97%
Computer Software & Hardware	6172 (1375)	11786 (2614)	(1410)	4642 (1092)	36809 (8370)	12.37%
Telecommunications	2776 (624)	2155 (478)	5103 (1261)	1295 (315)	18043 (4157)	6.065
Construction	667 (151)	4424 (985)	6989 (1743)	6224 (1483)	19606 (4646)	6.59%
Automobile	630 (143)	1254 (276)	2697 (675)	1792 (441)	11648 (2678)	3.92%
Housing and Real estate	171 (38)	2121 (467)	8749 (2179)	5480 (1315)	16642 (4026)	5.59%
Power	386 (87)	713 (157)	3875 (967)	2124 (520)	11754 (2725)	3.95%
Metallurgical	6540 (147)	7866 (173)	4686 (1177)	3208 (766)	10556 (2528)	3.55%
Chemicals (Other than fertilizers)	1731 (390)	930 (205)	920 (229)	1261 (301)	7401 (1686)	2.49%
Petroleum & Natural Gas	64 (14)	401 (89)	5729 (1427)	263 (62)	8509 (2043)	2.86%

Figures in bracket are in US$ million

* In terms of ₹

Source: DIPP, Federal Ministry of Commerce and Industry, Government of India

Notes

7.6.2 India's Share in Global Scenario

India's share in the global scenario is interesting-outflows exceed inflows. The outflows comprise cross border acquisitions. The number of deals involving acquisitions has been increasing, year after year. In monetary terms (according to the RBI), FDI outflows have increased from US $ 709 million in 2000–01 to US $1494 million in 2003–04 and then almost doubled to US $ 2679 million in 2005–06. The outflow during 2006–07 is estimated at $ 35 billion.

But the issue is the inflow of FDI into India. India needs FDI much more than any other developing country. Realizing this, the Government of India has been adopting various structural reform measures and making changes in the regulatory framework to encourage FDI flow into the country. In the beginning of the 90s, India devalued the Indian Rupee twice, and made Rupee convertible on the current account. India has signed the multilateral investors' protection treaty to protect the interest of the foreign investors. For speedy approval of various FDI proposals, the Foreign Investment Promotion Board (FIPB) has been set up. For reducing the time lag between approval and implementation of these projects, the Foreign Investment Implementation Authority (FIIA) has been set up recently.

Apart from various structural reform measures and regulatory changes, the government is continuously evolving and implementing FDI promotion measures. As a part of these measures, the government has opened up all sectors of the economy, except agriculture and plantation, for foreign investors, both Non-resident Indians (NRIs) and Foreign Institutional Investors (FIIs). NRIs are permitted to invest up to 100 per cent of equity under automatic approval of 51 priority sectors with responsibility of capital. This limit for the FII's is 51 per cent. In some of the priority sectors, the FII's can even invest 74 per cent of the equity. Foreign investors are also allowed to invest in banking and financial institutions.

7.6.3 Measures Adopted to Attract FDI

In table contains some other promotional measures announced to attract FDI flow into the country. Perhaps the most important of these relaxations from the foreign investor's viewpoint was the discontinuation, in 2000, of the provision for 'dividend balancing' in 22 categories of industries (mainly consumer goods/consumer durables). Under this provision, dividends repatriated to the parent country had to be balanced by export earnings over a seven-year period, such exports being optionally from own production or merchant exports.

Table 7.6: Measures to Attract FDI

1992	Foreign firms obtained automatic rights over international brand names.
1993	Requirement for industrial licensing in specified industries (white goods, entertainment electronics) abolished FIIs allowed to invest in new Mutual Fund schemes.
1994	Banks allowed to set their own rates for lending. Companies allowed to issue preferential equity to FIIs.
1996	Overseas pension funds, charities, foundations qualify as FIIs FIIs allowed to invest in unlisted firms. FIIs allowed to invest 100% of funds (previous 30%) in debt instruments.
1998	Further concessions to FIIs, now allowed to invest in Government securities, Treasury Bills, listed and unlisted debt securities.
1999	FIIs allowed conditional forward foreign exchange cover. FIIs could participate in open offers in accordance with take over codes.
2000	100% foreign equity allowed in infrastructure projects – ports, roads, highways.
2002	Limited FDI in print media permitted.

Notes

Further changes are:

Indian companies can make overseas investments by market purchase of foreign exchange without prior approval of the RBI up to 100 per cent of their net worth. The previous limit was US $100 million and less than 50 per cent of the net worth.

- The annual limit on investment abroad has been raised from US $50 million to US $100 million.
- Overseas investments are allowed to be funded up to 100 per cent by American Depositary Receipts. General Depositary Receipts proceeds. The earlier limit was 50 per cent.
- Overseas investments are opened to registered partnership firms that offer professional services.
- Overseas investors are permitted to invest abroad in areas unrelated to their business at home.
- This is by no means comprehensive: several other measures, such as the repeal of the draconian Foreign Exchange Regulations Act in favour of FEMA (Foreign Exchange Management Act) served directly or indirectly as stimuli for foreign investment. The Government also periodically announced, by means of formal notifications, relaxations in the percentage of foreign equity permissible in different industries. The term 'relaxation' must be stressed, in no instance has there been a tightening or reversion.

Areas where FDI is permitted: FDI is allowed under two routes, automatic route (where RBI approval is required) and non-automatic route (where approval from government is required). In the following areas, 100 per cent FDI is allowed.

Automatic Route

- Airports
- B2B e-commerce
- Trading companies within notified policy
- Drugs and pharmaceuticals not falling under the automatic route
- Integrated township development
- ISPs without gateways, electronic mail and voice mail
- Courier services other than distribution of letters
- Most manufacturing activities other than those which attract compulsory licensing/sectoral equity cap or are reserved exclusively in small scale industries
- Non-banking financial services
- Infrastructure such as roads and highways, ports and harbours, electricity generation, transmission and distribution, mass rapid transit systems and LNG project
- Drugs and pharmaceuticals that do not attract compulsory licensing and involve recombinant
- DNA technology
- Hotels and tourism
- Food processing
- Electronic hardware
- Software development

Notes

- Film industry
- Hospitals
- Private oil refineries
- Pollution control and management
- Exploration and mining of minerals other than diamonds and precious stones
- Management consultancy
- Venture capital funds/companies

Caution The above is only broad categorization and may need fine tuning and updations. For example in Civil Aviation and Broadcasting there are subcategories with different percentage of FDI allowed.

Self Assessment

Fill in the blanks:

9. India's share in the ..... scenario is interesting-outflows exceed inflows.
10. In the ..... of the 90s, India devalued the Indian Rupee twice, and made Rupee convertible on the current account.
11. India has signed the ..... investors' protection treaty to protect the interest of the foreign investors.
12. For speedy approval of various ..... proposals, the Foreign Investment Promotion Board (FIPB) has been set up.
13. ..... and ..... are the two major countries holding first and the second position in the investor's list of FDI in India.
14. The ..... comprise cross border acquisitions.
15. FDI is allowed under two routes, ... and ..... .

Case Study **The L&T Saga Continues**

The L&T, the huge engineering and construction multi-plant organisation, founded in 1938 by two Danish engineers, Henning Holck-Larsen and Soren Kristin Toubro.

Henning Holck-Larsen and Soren Kristin Toubro, school-mates in Denmark, would not have dreamt, as they were learning about India in history classes that they would, one day, create history in that land. In 1938, the two friends decided to forgo the comforts of working in Europe and started their own operation in India. All they had was a dream. And the courage to dare. Their first office in Mumbai (Bombay) was so small that only one of the partners could use the office at a time! Today, L&T is one of India's biggest and best known industrial organizations with a reputation for technological excellence, high quality of products and services and strong customer orientation.

As on today, L&T is a 62 business conglomerate with a turnover of ₹ 18,363 crore (2006–07), with the script commanding ₹ 2400 in the bourses. No, L&T is not sitting pretty.

Contd...

Notes

L&T want to hit ₹ 30,000 crore turnover mark by 2010 and is busy restructuring, sniffing new pastures, grooming new talent and projecting the new company credo – "It's All About Imagineering." With the sole idea of creating several MNCs within, with footprints across nations, L&T is shedding the old economy and embracing the emergent opportunities and challenges.

Stagnant Revenues and Low Margins

Not everything went the L&T way. In the late nineties, the macro environment was not very inspiring with stagnant revenues and low margins, and L&T's core strength, its engineers, were being constantly weaned away by the fast growing software sector. So, the general comment around the bourses was about the credibility of the company, 'L&T is a, good company but its stock price, for some reason or the other, is fixed at the ₹ 140-210 band. So the company had to change by keeping its core intact. As Senior Executive remarks, "L&T was perceived to be un-sexy and we had to create a new buzz around the campuses." The metamorphosis must echo through a whimper, not a bang. Even before the company divested its cement business in 2003, which accounted for 25% of its total sales, there were years of incremental and low visibility organisational moves towards a new L&T.

At a 52-week high of ₹ 2400, the L&T scrip today looks dapper, a far cry from the nineties when the stock price was in a state of flux. Much of the change started as a ripple way back in 1999 when Naik took over as the CEO. He visited employees at all levels across the organisation and asked them what it took to transform the company. The insights were mapped and implemented. "None of our employees thought that we build shareholder value. They thought we build monuments," the chairman reminisces. The focus on people became stronger and formed the basis of restructuring. It became the first old economy company to provide stock options to its employees.

When Naik came to the helm, he set upon himself a 90-day transformational agenda. Portfolios were reviewed and a vision clearly chalked out. He drew up a simple, brief, 'L&T has to be a multinational company and it has to deliver shareholder value at any cost. At the end of 90 days, between July 22 and July 24, 1999, the company launched Project Blue Chip, which essentially fast-tracked projects. The moot point was to complete all projects by February of the new millennium. Strategy formation teams were formed, portfolios reviewed and structures were optimized. Young leadership was brought to the fore and the business streamlining process kicked in.

Hiving off from 1999-2001, L&T went about de-bottlenecking its cement plants. They were modernized and capacities were raised from 12 million tonnes to 16 million tonnes annually, with minimum costs. The mantra really was to grow the business and then divest it as cement fell in the non-core category.

So, in September 2003, L&T sold its cement business to the Aditya Birla Group, which resulted in the company's Economic Value Add (EVA), an important indicator of' the financial health of the Company, swinging from a negative ₹ 350 crore to a positive ₹ 50 crore immediately. The move, also, enabled L&T to reduce its debt-equity ratio from 1:1 to 0.2:1. Analysts took a positive' view of the de-merger, and re-rated L&T as AAA from AA+ in 2004.

From then on, began L&Ts transformation into a lean and mean machine. In 2004, the company envisaged a growth curve for the next, five years. This marked the beginning of Project Lakshya, which was centered on people operations, capabilities and new ventures. The company set out with over 300 initiatives in hand, and also placed a rigorous risk management system. For instance, any project above ₹ 1000 crore needed the signature of the chairman, Project Lakshya is known for targeting and selecting the right projects.

Contd...

Notes

By now, "the Indian, economy had started witnessing unprecedented boom" and despite divesting the cement business, the L&T turnover scaled the ₹ 10,000 crore mark. Alongside, the lucrative Middle East market was booming and L&T forayed into six countries in the Gulf with joint ventures. "The idea was to develop a mini L&T in the region," observes a senior company executive. The company also set up manufacturing facilities in China to leverage the cost structure. Exports in 2007 constituted 18% of net sales. With soaring revenues and operating margins, L&T started benchmarking itself with the best in the world.

Suddenly, the notion of an Indian MNC became a reality. L&T has big plans to foray into new businesses. The new businesses are:

Ship-building: L&T is getting into ship-building by building a world-class facility; and already has a 'small shipyard in Hazira. It will build complex oceangoing ships for the first time in India.

Power equipment: It is getting into power equipment in a big way. A JV with Mitsubishi for super critical boilers formed another with Toshiba for turbines on the way.

Financial services: L&T is rapidly increasing its presence in infrastructure finance. It is also planning to come up with a $1 billion infrastructure fund.

Railways: A new area, L&T aims to be an end-to-end solutions provider for the railways, from track-laying to signaling to transmission, and others.

Thus, for an institution that has grown to legendary proportions, there cannot and must not be an 'end'. Unlike other stories, the L&T saga continues.

Questions

1. Having a strong presence in India, what drives L&T to think of emerging a strong MNC?
2. What challenges lie ahead of L&T? How is it prepared to cope with them?
3. Will the L&T saga continue?

Source: The Economic Times, September 2, 2007 and company website: www.lntecc.com

7.7 Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- Foreign direct investment occurs when a firm invests directly in facilities to produce a product in a foreign country. It also occurs when a firm buys an existing enterprise in a foreign country.
- Horizontal FDI is FDI in the same industry abroad as a firm operates at home. Vertical FDI is FDI in an industry abroad that provides inputs into or sells output from a firm's domestic operations.
- Several factors characterized FDI trends over the past 20 years; (a) there has been a rapid increase in the total volume of FDI undertaken, (b) there has been some decline in the relative importance of the United States as a source for FDI, while several other countries have increased their share of total FDI outflows, (c) an increasing share of FDI seems to be directed at the developing nations of Asia and Eastern Europe, while the United States has become a major recipient of FDI, and (d) there has been an increase in the amount of FDI undertaken by firms based in developing nations.
- High transportation costs and/or tariffs imposed on imports help explain why many firms prefer horizontal FDI or licensing over exporting.

Notes

- Impediments to the sale of know-how explain why firms prefer horizontal FDI to licensing These impediments arise 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 to maximize its market share and earnings in that country, and (c) a firm's skills and know-how are not amenable to licensing.
- Knickerbocker's theory suggests that much FDI is explained by imitative strategic behaviour by rival firms in an oligopolistic industry.
- Vermon's product life cycle theory suggests that firm's undertake FDI at particular stages in the life cycle of products they have pioneered.
- 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.
- Backward vertical FDI may be explained as an attempt to create barriers to entry by gaining control over the source of material inputs into the down stream stage of a production process. Forward vertical FDI may be seen as an attempt to circumvent entry barriers and gain access to national market.
- The market imperfections approach suggests that vertical FDI is a way of reducing a firm's exposure to the risks that arise from investments in specialized assets.
- From a business prescriptive, the most useful theory is probably the market imperfections approach, because it identifies how the relative profit rates associated with horizontal FDI, exporting, and licensing vary with circumstances.
- The benefits of FDI to a host country arise from resource-transfer effects, employment effects, balance of payments effects, and its ability to promote competition.
- The costs of FDI to a host country include adverse effects on competition and balance of payments and a perceived loss of national sovereignty.
- 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.
- 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.

7.8 Keywords

Backward Vertical FDI: It is an attempt to create barriers to entry by gaining control over the source of material inputs into the down stream stage of a production process.

Foreign Direct Investment (FDI): Direct investment in business operations in foreign country.

Forward Vertical FDI: It is an attempt to circumvent entry barriers and gain access to national market.

Horizontal Foreign Direct Investment: Foreign direct investment in the same industry abroad as a firm operates in at home.

Market Imperfections: These are factors that restrain markets from working perfectly.

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.

Notes

7.9 Review Questions

1. What is international investment or foreign investment? What are the basic facts which help in distinguishing foreign direct investment and foreign portfolio investment (FPI)?
2. Discuss the benefits of FDI to the home court and to the host country.
3. What are the factors affecting international investment? Discuss four E's of international investment.
4. What is FDI? State and explain the factors that influence FDI.
5. Why do countries want FDI?
6. Explain Eclectic Theory and internationalization theory of international trade.
7. Discuss the global trends of FDI. What are new developments in FDI policies?
8. Explain Indian foreign investment policy. What measures have been adopted to attract FDI?
9. What are the major incentives for developed countries to invest in developing countries?
10. What are the advantages and disadvantages of FDI as compared to a licensing agreement with a foreign partner?
11. Recently, many foreign firms from both developed and developing countries acquired high tech US firms. What might have motivated these firms to acquire US firms?
12. Japanese MNCs such as Toyota, Toshiba and Matsushita made extensive investment in South East Asian countries like Thailand, Malaysia, Indonesia and India. In your opinion, what forces are driving Japanese investments in these regions?
13. Inward FDI is bad for (a) A developing economy and (b) A developed economy and should be subjected to strict controls! Discuss.
14. Compare and contrast these explanations of horizontal FDI: the market imperfections approach, Vermon'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 horizontal FDI? Why?
15. Compare and contrast these explanations of vertical FDI: the strategic behaviour approach the market imperfections approach. Which theory do you think offers the best explanation of the historical pattern of vertical FDI? Why?

Answers: Self Assessment

1. Imperfections
2. Economic
3. Vertical
4. John Dunning
5. Imperfections
6. (e)
7. Resource transfer effects, employment effects, Balance of payment effects, effect on competition and economic growth
8. Capital, technology, management resources

Notes

9. Global
10. Beginning
11. Multilateral
12. FDI
13. Mauritius and United states
14. Outflows
15. Automatic route and non-automatic route

7.10 Further Readings

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Unit 8: World Trade Organization

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Objectives

After studying this unit, you should be able to:

- Describe the various instruments of trade policy & political and economic arguments for government intervention in international trade
- Re-examine the economic case for free trade in the light of the strategic trade policy argument and re-look at the evolution of the world trading framework

Introduction

Our review of the classical trade theories of Smith, Ricardo, and Heckscher-Ohlin in 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.

Notes

In this unit, we look at the political reality of international trade. The political reality is that which many nations are nominally committed to free trade, they tend to intervene in international trade to protect the interests of politically important groups.

In this unit, we explore 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 exports. Normally, their moves are to protect domestic producers and jobs from foreign competition while increasing the foreign market for products of domestic producers.

8.1 World Trade Organization

The World Trade Organization deals with the rules of trade between nations at a near-global level; it is responsible for negotiating and implementing new trade agreements, and is in charge of policing member countries' adherence to all the WTO agreements, signed by the bulk of the world's trading nations and ratified in their parliaments. Most of the WTO's current work comes from the 1986–94 negotiations called the Uruguay Round, and earlier negotiations under the GATT. The organization is currently the host to new negotiations, under the Doha Development Agenda (DDA) launched in 2001.

The WTO is governed by a Ministerial Conference, which meets every two years; a General Council, which implements the conference's policy decisions and is responsible for day-to-day administration; and a Director-General, who is appointed by the Ministerial Conference. The WTO's headquarters are in Geneva, Switzerland.

8.1.1 Mission, Functions and Principles

The WTO's stated goal is to improve the welfare of the peoples of its member countries, specifically by lowering trade barriers and providing a platform for negotiation of trade. Its main mission is "to ensure that trade flows as smoothly, predictably and freely as possible". This main mission is further specified in certain core functions serving and safeguarding five fundamental principles, which are the foundation of the multilateral trading system.

Functions

Among the various functions of the WTO, these are regarded by analysts as the most important:

1. It oversees the implementation, administration and operation of the covered agreements.
2. It provides a forum for negotiations and for settling disputes.

Additionally, it is the WTO's duty to review the national trade policies, and to ensure the coherence and transparency of trade policies through surveillance in global economic policy-making. Another priority of the WTO is the assistance of developing, least-developed and low-income countries in transition to adjust to WTO rules and disciplines through technical co-operation and training. The WTO is also a center of economic research and analysis: regular assessments of the global trade picture in its annual publications and research reports on specific topics are produced by the organization. Finally, the WTO co-operates closely with the two other components of the Bretton Woods system, the IMF and the World Bank.

Principles of the Trading System

Notes

Some of them are discussed as under:

1. ***Trade without discrimination:***

   (i) *Most-favoured-nation (MFN):* Treating other people equally under the WTO agreements, countries cannot normally discriminate between their trading partners. Grant someone a special favour (such as a lower customs duty rate for one of their products) and you have to do the same for all other WTO members.

   This principle is known as most-favoured-nation (MFN) treatment. It is so important that it is the first article of the General Agreement on Tariffs and Trade (GATT), which governs trade in goods. MFN is also a priority in the General Agreement on Trade in Services (GATS) (Article 2) and the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS) (Article 4), although in each agreement the principle is handled slightly differently. Together, those three agreements cover all three main areas of trade handled by the WTO.

   Some exceptions are allowed. For example, countries can set up a free trade agreement that applies only to goods traded within the group — discriminating against goods from outside. Or they can give developing countries special access to their markets. Or a country can raise barriers against products that are considered to be traded unfairly from specific countries. And in services, countries are allowed, in limited circumstances, to discriminate. But the agreements only permit these exceptions under strict conditions. In general, MFN means that every time a country lowers a trade barrier or opens up a market, it has to do so for the same goods or services from all its trading partners — whether rich or poor, weak or strong.

   (ii) *National treatment – Treating foreigners and locals equally:* Imported and locally produced goods should be treated equally — at least after the foreign goods have entered the market. The same should apply to foreign and domestic services, and to foreign and local trademarks, copyrights and patents. This principle of "national treatment" (giving others the same treatment as one's own nationals) is also found in all the three main WTO agreements (Article 3 of GATT, Article 17 of GATS and Article 3 of TRIPS), although once again the principle is handled slightly differently in each of these.

   National treatment only applies once a product, service or item of intellectual property has entered the market. Therefore, charging customs duty on an import is not a violation of national treatment even if locally-produced products are not charged an equivalent tax.

2. ***Freer trade: gradually, through negotiation:*** Lowering trade barriers is one of the most obvious means of encouraging trade. The barriers concerned include customs duties (or tariffs) and measures such as import bans or quotas that restrict quantities selectively. From time-to-time other issues such as red tape and exchange rate policies have also been discussed.

   Since GATT's creation in 1947–48 there have been eight rounds of trade negotiations. A ninth round, under the Doha Development Agenda, is now underway. At first these focused on lowering tariffs (customs duties) on imported goods. As a result of the negotiations, by the mid-1990s industrial countries' tariff rates on industrial goods had fallen steadily to less than 4%.

   But by the 1980s, the negotiations had expanded to cover non-tariff barriers on goods, and to the new areas such as services and intellectual property.

Notes

Opening markets can be beneficial, but it also requires adjustment. The WTO agreements allow countries to introduce changes gradually, through "progressive liberalization". Developing countries are usually given longer to fulfill their obligations.

3. ***Predictability: through binding and transparency:*** Sometimes, promising not to raise a trade barrier can be as important as lowering one, because the promise gives businesses a clearer view of their future opportunities. With stability and predictability, investment is encouraged, jobs are created and consumers can fully enjoy the benefits of competition — choice and lower prices. The multilateral trading system is an attempt by governments to make the business environment stable and predictable.

   In the WTO, when countries agree to open their markets for goods or services, they "bind" their commitments. For goods, these bindings amount to ceilings on customs tariff rates. Sometimes countries tax imports at rates that are lower than the bound rates. Frequently this is the case in developing countries. In developed countries the rates actually charged and the bound rates tend to be the same.

   A country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. One of the achievements of the Uruguay Round of multilateral trade talks was to increase the amount of trade under binding commitments. In agriculture, 100% of products now have bound tariffs. The result of all this a substantially higher degree of market security for traders and investors.

   The system tries to improve predictability and stability in other ways as well. One way is to discourage the use of quotas and other measures used to set limits on quantities of imports — administering quotas can lead to more red-tape and accusations of unfair play. Another is to make countries' trade rules as clear and public ("transparent") as possible. Many WTO agreements require governments to disclose their policies and practices publicly within the country or by notifying the WTO. The regular surveillance of national trade policies through the Trade Policy Review Mechanism provides a further means of encouraging transparency both domestically and at the multilateral level.

4. ***Promoting fair competition:*** The WTO is sometimes described as a "free trade" institution, but that is not entirely accurate. The system does allow tariffs and, in limited circumstances, other forms of protection. More accurately, it is a system of rules dedicated to open, fair and undistorted competition.

   The rules on non-discrimination — MFN and national treatment — are designed to secure fair conditions of trade. So too are those on dumping (exporting at below cost to gain market share) and subsidies. The issues are complex, and the rules try to establish what is fair or unfair, and how governments can respond, in particular by charging additional import duties calculated to compensate for damage caused by unfair trade.

   Many of the other WTO agreements aim to support fair competition: in agriculture, intellectual property, services, e.g., the agreement on government procurement (a "plurilateral" agreement because it is signed by only a few WTO members) extends competition rules to purchases by thousands of government entities in many countries. And so on.

5. ***Encouraging development and economic reform:*** The WTO system contributes to development. On the other hand, developing countries need flexibility in the time they take to implement the system's agreements. And the agreements themselves inherit the earlier provisions of GATT that allow for special assistance and trade concessions for developing countries.

Over three quarters of WTO members are developing countries and countries in transition to market economies. During the seven and a half years of the Uruguay Round, over 60 of these countries implemented trade liberalization programmes autonomously. At the same time,

developing countries and transition economies were much more active and influential in the Uruguay Round negotiations than in any previous round, and they are even more so in the current Doha Development Agenda.

At the end of the Uruguay Round, developing countries were prepared to take on most of the obligations that are required of developed countries. But the agreements gave them transition periods to adjust to the more unfamiliar and, perhaps, difficult WTO provisions — particularly so for the poorest, "least-developed" countries. A ministerial decision adopted at the end of the round says better off countries should accelerate implementing market access commitments on goods exported by the least-developed countries, and it seeks increased technical assistance for them. More recently, developed countries have started to allow duty-free and quota-free imports for almost all products from least-developed countries. On all of this, the WTO and its members are still going through a learning process. The current Doha Development Agenda includes developing countries' concerns about the difficulties they face in implementing the Uruguay Round agreements.

8.1.2 Formal Structure

According to WTO rules, all WTO members may participate in all councils, committees, etc., except Appellate Body, Dispute Settlement panels, and plurilateral committees.

Highest Level: Ministerial Conference

The topmost decision-making body of the WTO is the Ministerial Conference, which has to meet at least every two years. It brings together all members of the WTO, all of which are countries or separate customs territories. The Ministerial Conference can make decisions on all matters under any of the multilateral trade agreements.

Second Level: General Council

The daily work of the Ministerial Conference is handled by three groups: the General Council, the Dispute Settlement Body, and the Trade Policy Review Body. All three consist of the same membership – representatives of all WTO members – but each meets under different rules.

1. The General Council, the WTO's highest-level decision-making body in Geneva, meets regularly to carry out the functions of the WTO. It has representatives (usually ambassadors or equivalent) from all member governments and has the authority to act on behalf of the Ministerial Conference which only meets about every two years. The council acts on behalf on the Ministerial Council on all of the WTO affairs. The current chairman is Amb. Muhamad Noor Yacob (Malaysia).
2. The Dispute Settlement Body is made up of all member governments, usually represented by ambassadors or equivalent. The current chairperson is H.E. Mr. Bruce Gosper (Australia).
3. The WTO General Council meets as the Trade Policy Review Body (TPRB) to undertake trade policy reviews of Members under the TRPM. The TPRB is thus open to all WTO Members. The current chairperson is H.E. Ms. Claudia Uribe (Colombia).

Third Level: Councils for Trade

The Councils for Trade work under the General Council. There are three councils – Council for Trade in Goods, Council for Trade-related Aspects of Intellectual Property Rights, and Council for Trade in Services – each council works in different fields. Apart from these three councils, six other bodies report to the General Council reporting on issues such as trade and development, the environment, regional trading arrangements and administrative issues.

Notes

1. ***Council for Trade in Goods:*** The workings of the General Agreement on Tariffs and Trade (GATT) which covers international trade in goods, are the responsibility of the Council for Trade in Goods. It is made up of representatives from all WTO member countries. The current chairperson is Amb. Yonov Frederick Agah (Nigeria).
2. ***Council for Trade-related Aspects of Intellectual Property Rights:*** Information on intellectual property in the WTO, news and official records of the activities of the TRIPS Council, and details of the WTO's work with other international organizations in the field.
3. ***Council for Trade in Services:*** The Council for Trade in Services operates under the guidance of the General Council and is responsible for overseeing the functioning of the General Agreement on Trade in Services (GATS). It's open to all WTO members, and can create subsidiary bodies as required.

Fourth Level: Subsidiary Bodies

There are subsidiary bodies under each of the three councils.

1. ***Goods Council:*** Subsidiary under the Council for Trade in Goods. It has 11 committees consisting of all member countries, dealing with specific subjects such as agriculture, market access, subsidies, anti-dumping measures and so on. Committees include the following:
   (a) Information Technology Agreement (ITA) Committee
   (b) State Trading Enterprises
   (c) Textiles Monitoring Body – Consists of a chairman and 10 members acting under it.
   (d) Groups dealing with notifications – process by which governments inform the WTO about new policies and measures in their countries.
2. ***Services Council:*** Subsidiary under the Council for Trade in Services which deals with financial services, domestic regulations and other specific commitments.
3. ***Dispute Settlement Panels and Appellate Body:*** Subsidiary under the Dispute Settlement Body to resolve disputes and the Appellate Body to deal with appeals.

Other Committees

1. ***Committees on:***
   (a) Trade and Environment
   (b) Trade and Development (Sub-committee on Least-Developed Countries)
   (c) Regional Trade Agreements
   (d) Balance of Payments Restrictions
   (e) Budget, Finance and Administration
2. ***Working parties on:***
   (a) Accession
3. ***Working groups on:***
   (a) Trade, debt and finance
   (b) Trade and technology transfer

The WTO operates on a *one country, one vote* system, but actual votes have never been taken. Decision-making is generally by consensus, and relative market size is the primary source of bargaining power. The advantage of consensus decision-making is that it encourages efforts to find the most widely acceptable decision. Main disadvantages include large time requirements and many rounds of negotiation to develop a consensus decision, and the tendency for final agreements to use ambiguous language on contentious points that makes future interpretation of treaties difficult.

In reality, WTO negotiations proceed not by consensus of all members, but by a process of informal negotiations between small groups of countries. Such negotiations are often called "Green Room" negotiations (after the colour of the WTO Director-General's Office in Geneva), or "Mini-Ministerials", when they occur in other countries. These processes have been regularly criticized by many of the WTO's developing country members which are often totally excluded from the negotiations. Richard Steinberg (2002) argues that although the WTO's consensus governance model provides law-based initial bargaining, trading rounds close through power-based bargaining favouring Europe and the United States, and may not lead to Pareto improvement.

Self Assessment

Fill in the blanks:

1. The ..... operates on a *one country, one vote* system, but actual votes have never been taken.
2. The Councils for ..... under the General Council.
3. The WTO system tries also to improve ..... and stability, discouraging the use of quotas and other measures used to set limits on quantities of imports.
4. The World Trade Organization deals with the rules of trade between ..... at a near-global level.
5. The WTO's stated goal is to improve the ..... of the peoples of its member countries, specifically by lowering trade barriers and providing a platform for negotiation of trade.

8.1.3 Dispute Settlement

Prompt compliance with recommendations or rulings of the DSB is essential in order to ensure effective resolution of disputes to the benefit of all Members.

— World Trade Organization, Article 21.1 of the DSU

In 1994, the WTO members agreed on the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU) annexed to the "Final Act" signed in Marrakesh in 1994. Dispute settlement is regarded by the WTO as the central pillar of the multilateral trading system, and as a "unique contribution to the stability of the global economy". WTO members have agreed that, if they believe fellow-members are violating trade rules, they will use the multilateral system of settling disputes instead of taking action unilaterally.

Duration of a Dispute Settlement Procedure

These approximate periods for each stage of a dispute settlement procedure are target figures.

The agreement is flexible. In addition, the countries can settle their dispute themselves at any stage.

Notes

Totals are also approximate.

60 days	Consultations, mediation, etc
45 days	Panel set up and panelists appointed
6 months	Final panel report to parties
3 weeks	Final panel report to WTO members
60 days	Dispute Settlement Body adopts report (if no appeal)
Total = 1 year (without appeal)	
60-90 days	Appeals report
30 days	Dispute Settlement Body adopts appeals report
Total = 1 year 3 months (with appeal)	

Source: Understanding the WTO: Settling Disputes - A unique contribution

The operation of the WTO dispute settlement process involves the DSB panels, the Appellate Body, the WTO Secretariat, arbitrators, independent experts and several specialized institutions. The General Council discharges its responsibilities under the DSU through the Dispute Settlement Body (DSB). Like the General Council, the DSB is composed of representatives of all WTO Members. The DSB is responsible for administering the DSU, i.e. for overseeing the entire dispute settlement process. If a member state considers that a measure adopted by another member state has deprived it of a benefit accruing to it under one of the covered agreements, it may call for consultations with the other member state. If consultations fail to resolve the dispute within 60 days after receipt of the request for consultations, the complainant state may request the establishment of a panel. It is not possible for the respondent state to prevent or delay the establishment of a panel, unless the DSB by consensus decides otherwise. The panel, normally consisting of three members appointed *ad hoc* by the Secretariat, sits to receive written and oral submissions of the parties, on the basis of which it is expected to make findings and conclusions for presentation to the DSB. The proceedings are confidential, and even when private parties are directly concerned, they are not permitted to attend or make submissions separate from those of the state in question.

The final version of the panel's report is distributed first to the parties, and two weeks later it is circulated to all the members of the WTO. The report must be adopted at a meeting of the DSB within 60 days of its circulation, unless the DSB by consensus decides not to adopt the report or a party to the dispute gives notice of its intention to appeal. A party may appeal a panel report to a standing Appellate Body, but only on issues of law, and legal interpretations developed by the panel. Members may express their views on the report of the Appellate Body, but they cannot derail it: an Appellate Body report shall be adopted by the DSB and unconditionally accepted by the parties, unless the DSB decides by consensus within thirty days of its circulation not to adopt the report.

Within thirty days of the adoption of the report, the member concerned is to inform the DSB of its intentions; if the member explains that it is impracticable to comply immediately with the recommendations and rulings, it is to have a "reasonable period of time" in which to comply. If no agreement is reached about the reasonable period for compliance, that issue is to be the subject of binding arbitration. If there is a disagreement as to the satisfactory nature of the measures adopted by the respondent state to comply with the report that disagreement is to be decided by a panel, if possible the same panel that heard the original dispute, but apparently without the possibility of appeal from its decision.

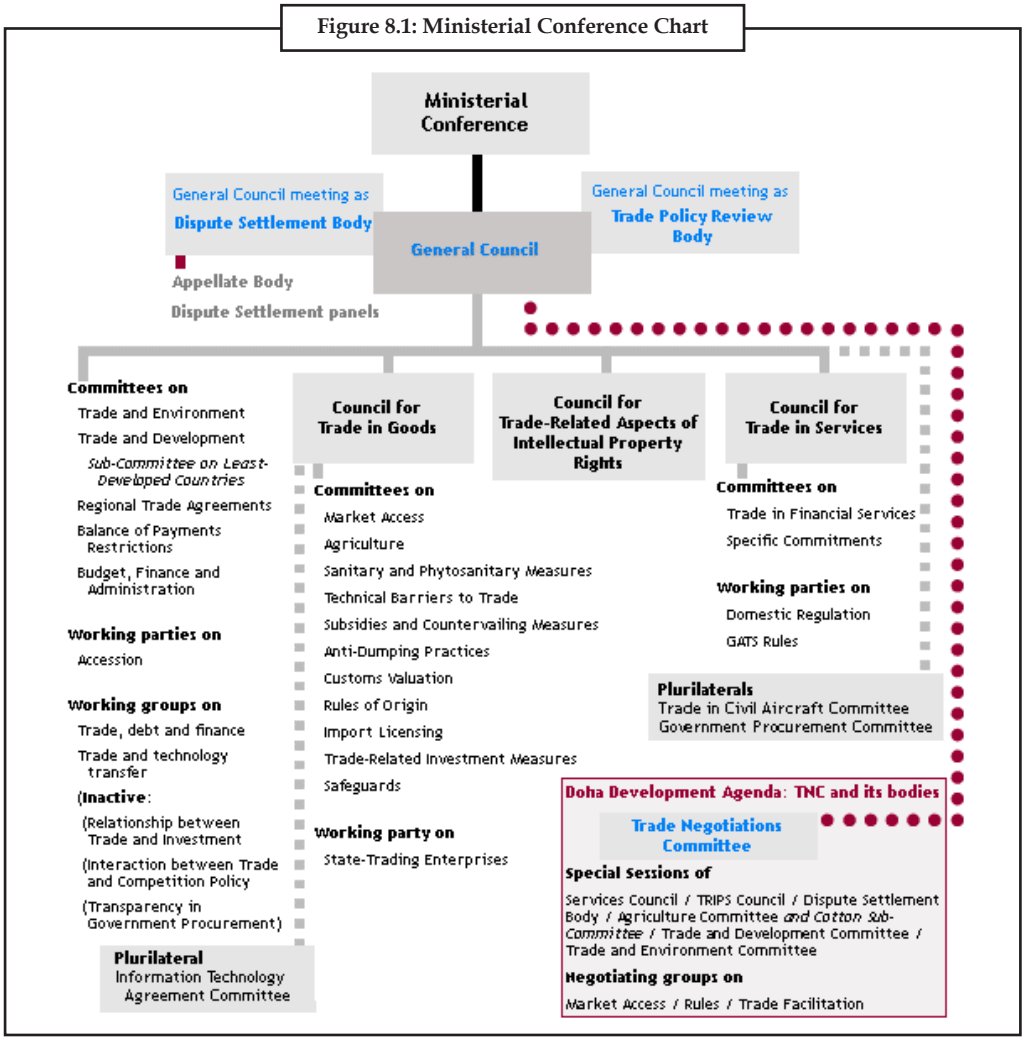
If all else fails, two more possibilities are set out in the DSU:

1. If a member fails within the "reasonable period" to carry out the recommendations and rulings, it may negotiate with the complaining state for a mutually acceptable compensation.
2. If no agreement on compensation is reached within twenty days of the expiry of the "reasonable period", the prevailing state may request authorization from the DSB to

Notes

suspend application to the member concerned of concessions or other obligations under the covered agreements. In contrast to prior GATT practice, authorization to suspend concessions in this context is semi-automatic, in that the DSB "shall grant the authorization [...] within thirty days of the expiry of the reasonable period", unless it decides by consensus to reject the request.

Figure 8.1: Ministerial Conference Chart



Reporting to General Council (or a subsidiary)

Reporting to Dispute Settlement Body

Plurilateral committees inform the General Council or Goods Council of their activities, although these agreements are not signed by all WTO members

Trade Negotiations Committee reports to General Council

The DSU states that fellow members should give "special attention" to the problems and interest of the developing countries. If one party to a dispute is a developing country, that party is entitled to have at least one panelist who comes from a developing country. Further, if a complaint is brought against a developing country, the time for consultations (before a panel is convened) may be expended, and if the dispute goes to a panel, the deadlines for the developing country to make its submissions may be relaxed. Formal complaints against least developed countries are discouraged, and if consultations fail, the Director-General and the Chairman of the DSB stand ready to offer their good offices before a formal request for a panel is made. As to substance, the DSU provides that "particular attention" is to be paid to the interests of the developing

Notes

countries, and that the report of panels shall "explicitly indicate" how account has been taken of the "differential and more favorable treatment" provisions of the agreement under which the complaint is brought. In order to assist developing countries overcome their limited expertise in WTO law and assist them in the management of complex trade disputes, an Advisory Centre on WTO Law was established in 2001.

The General Council also meets as the Trade Policy Review Body and Dispute Settlement Body.

The negotiations mandated by the Doha Declaration take place in the Trade Negotiations Committee and its subsidiaries. This now includes the negotiations on agriculture and services begun in early 2000. The TNC operates under the authority of the General Council.

Each year new chairpersons for the major WTO bodies are approved by the General Council.

Self Assessment

Fill in the blanks:

6. At the ..... WTO member governments agreed to launch new negotiations.
7. A new working group was set up on the last day of the ..... to discuss proposals for creating a labour standards working group within the WTO or a body operated jointly by a number of international organisation.
8. The WTO operates on a ..... system.
9. The general council also meets as the ..... and ..... .
10. Each year new chairpersons for the major WTO bodies are approved by the ..... .

8.1.4 Accession and Membership

The process of becoming a WTO member is unique to each applicant country, and the terms of accession are dependent upon the country's stage of economic development and current trade regime. The process takes about five years, on average, but it can last more if the country is less than fully committed to the process or if political issues interfere. As is typical of WTO procedures, an offer of accession is only given once consensus is reached among interested parties.

Accession Process

Status of WTO negotiations:

1. Members (including dual-representation with the European Communities);
2. Draft Working Party Report or Factual Summary adopted;
3. Goods and/or Services offers submitted;
4. Memorandum on Foreign Trade Regime submitted;
5. Observer, negotiations to start later or no Memorandum on FTR submitted;
6. Frozen procedures or no negotiations in the last 3 years; and
7. No official interaction with the WTO.

A country wishing to accede to the WTO submits an application to the General Council, and has to describe all aspects of its trade and economic policies that have a bearing on WTO agreements. The application is submitted to the WTO in a memorandum which is examined by a working party open to all interested WTO Members. After all necessary background information has been acquired, the working party focuses on issues of discrepancy between the WTO rules and the

applicant's international and domestic trade policies and laws. The working party determines the terms and conditions of entry into the WTO for the applicant nation, and may consider transitional periods to allow countries some leeway in complying with the WTO rules. The final phase of accession involves bilateral negotiations between the applicant nation and other working party members regarding the concessions and commitments on tariff levels and market access for goods and services. The new member's commitments are to apply equally to all WTO members under normal non-discrimination rules, even though they are negotiated bilaterally.

When the bilateral talks conclude, the working party sends to the General Council or Ministerial Conference an accession package, which includes a summary of all the working party meetings, the Protocol of Accession (a draft membership treaty), and lists ("schedules") of the member-to-be's commitments. Once the General Council or Ministerial Conference approves of the terms of accession, the applicant's Parliament must ratify the Protocol of Accession before it can become a member.

Notes The inaugural ministerial conference was held in Singapore in 1996.

Members and Observers

A map of WTO participation includes:

1. Members,
2. Members, dually represented with the European Communities,
3. Observer, ongoing accession,
4. Observer
5. Non-member, negotiations pending, and
6. Non-member.

The WTO has 151 members (almost all of the 123 nations participating in the Uruguay Round signed on at its foundation, and the rest had to get membership). The 27 states of the European Union are represented also as the European Communities. WTO members do not have to be full sovereign nation-members. Instead, they must be a customs territory with full autonomy in the conduct of their external commercial relations. Thus Hong Kong became a GATT contracting party, and Chinese Taipei (Taiwan) acceded to the WTO in 2002. A number of non-members have been observers (31) at the WTO and are currently negotiating their membership. With the exception of the Holy See, observers must start accession negotiations within five years of becoming observers. Some international intergovernmental organizations are also granted observer status to WTO bodies. 15 states and 2 territories so far have no official interaction with the WTO.

8.1.5 Agreements

The WTO oversees about 60 different agreements which have the status of international legal texts. Member countries must sign and ratify all WTO agreements on accession. A list of WTO agreements can be found here. A discussion of some of the most important agreements follows:

Agreement on Agriculture (AoA)

The AoA came into effect with the establishment of the WTO at the beginning of 1995. The AoA has three central concepts, or "pillars": domestic support, market access and export subsidies.

Notes

Domestic Support: The first pillar of the AoA is "domestic support". The AoA structures domestic support (subsidies) into three categories or "boxes": a Green Box, an Amber Box and a Blue Box. The Green Box contains fixed payments to producers for environmental programmes, so long as the payments are "decoupled" from current production levels. The Amber Box contains domestic subsidies that governments have agreed to reduce but not eliminate. The Blue Box contains subsidies which can be increased without limit, so long as payments are linked to production-limiting programmes.

The AoA's domestic support system currently allows Europe and the USA to spend $380 billion annually on agricultural subsidies alone. "It is often still argued that subsidies are needed to protect small farmers but, according to the World Bank, more than half of EU support goes to 1% of producers while in the US 70% of subsidies go to 10% of producers, mainly agri-businesses". The effect of these subsidies is to flood global markets with below-cost commodities, depressing prices and undercutting producers in poor countries – a practice known as dumping.

Market Access: "Market access" is the second pillar of the AoA, and refers to the reduction of tariff (or non-tariff) barriers to trade by WTO members. The 1995 AoA required tariff reductions of:

1. 36% average reduction by developed countries, with a minimum per tariff line reduction of 15% over five years.
2. 24% average reduction by developing countries with a minimum per tariff line reduction of 10% over nine years.

Least Developed Countries (LDCs) were exempted from tariff reductions, but either had to convert non–tariff barriers to tariffs—a process called tariffication—or "bind" their tariffs, creating a "ceiling" which could not be increased in future.

Export Subsidies: "Export subsidies" is the third pillar of the AoA. The 1995 AoA required developed countries to reduce export subsidies by at least 35% (by value) or by at least 21% (by volume) over the five years to 2000.

Criticism: The AoA is criticized for reducing tariff protections for small farmers – a key source of income for developing countries – while allowing rich countries to continue to pay their farmers massive subsidies which developing countries cannot afford.

8.1.6 General Agreement on Trade in Services (GATS)

GATS is a set of multilateral rules covering international trade in services. The GATS, for the first time, extended internationally agreed rules and commitments into the area of international trade in services.

The GATS has two parts: the framework agreement containing the general rules and disciplines, and the national "schedules" which list individual countries' specific commitments on access to their domestic markets by foreign suppliers

Each WTO member lists, in its national schedule, those services for which it wishes to guarantee access to foreign suppliers. All commitments apply on a non-discriminatory basis to all other members unlike the GATT, the GATS gives complete freedom to members to choose which services to commit for opening up. In addition to the services committed the schedules limit the degree to which foreign service providers can operate in the market.

Further negotiations for progressive liberalization (mandated negotiations) commenced on Jan 1, 2000 as mandated under GATS.

GATS in Brief: Services mentioned in GATS are supplied neither on a commercial basis nor in competition with other suppliers such as social security schemes and central banking so also services in the air transport sector, traffic rights and all services directly related to the exercise of traffic rights.

Notes

Modes of Supply: The GATS sets out four modes of supplying services:

1. Mode 1: Cross border trade
2. Mode 2: Consumption abroad
3. Mode 3: Commercial presence
4. Mode 4: Presence of natural persons

General Principles: These are basic rules that apply to all members for all services

1. ***MFN Treatment:*** This means that "Each member shall accord immediately and unconditionally to services and service suppliers of any other member, treatment no less, than it accords to like services and service suppliers of all other country." However a member is permitted to maintain a measure inconsistent with the general MFN agreement if it has established an exception.

   All exceptions are subject to review and in principle and do not last longer that 10 years.

2. ***Transparency:*** The GATS require each member to publish promptly all relevant measures of general application that affect operation of agreement

Specific Obligations: These requirements apply only to scheduled sectors:

1. ***Market Access:*** The GATS also sets out different forms of measures affecting free market access that should be applied to a service provider or its supplier only after clear provisions have been made in the member scheduled.

   The market access limitations include:

   (a) Limitation on the number of service suppliers,

   (b) Limitation on the total value of service transactions or assets,

   (c) Limitations on the total number of service operations or the total quantity of service output, and

   (d) Percentage limitations and the participation of foreign capital or the limitations on the total value of foreign investment.

2. ***National Treatment:*** Each member should treat to foreign services and service suppliers if measures affecting supply of services, no less favourably than to its own services and suppliers.

Exemptions: Members in specified circumstances are allowed to introduce or maintain measures in contravention of their obligations under the agreement, including the MFN requirement or specific commitments. These circumstances cover measures necessary to protect public morals or maintain public order, protect human, animal or plant life or health or secure compliance with laws or regulations not inconsistent with this Agreement including among others, measures necessary to prevent deceptive or fraudulent practices.

Irreversible Commitments: Member governments are always free to liberalise unilaterally without making commitments in the GATS. Nevertheless, GATS commitments like tariff bindings are not irreversible.

Regional Trading Arrangements: Apart from services provided in individual MFN exemption lists, the only permitted departure from most favoured-nation treatment under the GATS is among countries that are members of regional trading arrangements. The GATS rules on 'Economic Integration', in Article V, are modelled on those in Article XXIV ('Territorial Application-Frontier Traffic-Customs Unions and Free Trade Areas') of the GATT, although the absence of a services' equivalent to import duties means that there is no distinction comparable to that between customs unions and free trade area.

Notes

8.1.7 Trade-related Aspects of Intellectual Property Rights (TRIPs) Agreement

The main objective is to provide protection to the holder of the intellectual property right, which can be claimed by an individual, company or even people of a geographical region.

This right over an intellectual property can be called a 'monopoly right' conferred on the inventor (patent on an industrial product), creator (copyright over a literary work) or user (trademark of a business establishment) or regions (Geographical Indicators of Origin). This right, recognised as "legal property", however, can be claimed for fixed pre-determined periods of time except Trademarks and Geographical indications of Origin where protection is offered in perpetuity.

TRIPS coverage: The agreement encompasses the following areas:

- ***Patents:*** Patents are given inventions that are-new (or Novel), non–obvious, should have industrial application (commercial use).
  - *Term of a patent:* A parent is valid for 20 years from the date of filing of the patent.
  - *Inventions that can be patented:* Biological inventions, computer hardware and peripherals, computer software, cosmetics, food inventions, machines, mechanical inventions, medical accessories and devices, medicines, musical instruments etc.
  - *Inventions that cannot be patented:* Order public or morality; Diagnostic, therapeutic and surgical methods; plants and animals other than micro-organisms.
  - *Compulsory Licensing:* Compulsory licensing and government use without the authorisation of the right holder are allowed but are made subject to conditions aimed at protecting the legitimate interests of the right holder.
  - *Scope and Duration:* The scope and duration of such use without the authorisation of the right holder must be limited to the purpose for which it is authorised.
  - *Non-exclusive Licenses*
  - *Indian Patents Act:* The salient features are:
    - Terms of every patent are 20 years from the date of filing.
    - A new definition of 'invention' meaning a new product or process involving inventive step and capable of industrial application has been incorporated.
    - A method or process of testing during the process of manufacture will be patentable.
    - Process in case of plants, are now patentable while a process for diagnostic and therapeutic use has now been considered as non-patentable. Every patent (except in which a secrecy direction is given) will now be published just after 18 months from the date of filing/priority and will be open for public on payment. As such, the filing intimation being published in the Gazette immediately after filing has been stopped.
    - Provision for filing request for examination by any other interested person (other than applicant) also has been introduced.
    - Provision for the withdrawal of application by applicant any time before grant has been introduced.
    - Time for putting the application in order for acceptance has now been from 15/18 months to 12 months.
    - Grounds for opposition as well as revocation have been enlarged by adding the following grounds (i) Non-disclosure or wrongly mentioning the source of

geographical origin of biological material used for invention; (ii) Anticipation having regard to the knowledge, oral or otherwise available within local or indigenous community in India or elsewhere.

- ***Copyright:*** A copyright prohibits persons from reproducing or 'copying' any 'literary, dramatic, musical work' without the consent of the owner who has the copyright over that work. This protection also applies to cinematograph films, sound recordings and now, computer programmes.

  The TRIPS Agreement mentions that "copyright protection shall extend to expressions and not to ideas, procedures and methods of operation or mathematical concepts as such". Just as 'commercial use or utility' is an important precondition for the granting of a patent, ideas should have crystallised as expressions or artistic forms for the granting of a patent.

  Copyright subsists in the following class of 'works':

  - Literary Work;
  - Dramatic work; and
  - Artistic works.

- ***Trademarks:*** A trademark is a visual symbol in the form of a word, device, name, letter or numeral, brand, heading, signature or label or any combination of these that enable a person to make a connection between a product and the company involved in offering the product. The company can be one involved in manufacturing goods or offering services. In case of the latter, the term 'service mark' is used.

- ***Indian Act:*** The Trademarks Act of 1999 came into effect on September 15, 2003, mentions the grounds for refusal of registration of a trademark. The reasons could be when the trademark:

  - Is devoid of any distinctive character, that there is difficulty in distinguishing between goods or services;
  - Consists exclusively of marks or indications which have become customary in the current language, that is, an absence of distinctiveness;
  - Is of such a nature as to deserve the public or cause confusion;
  - Contains or comprises any matter that hurts religious feelings;
  - Comprises or contains scandalous or obscene matter; and
  - Consists exclusively of the shape of a good, e.g. the photo of mango by itself cannot be a trademark.

  Under the Trade Marks Act of 1999, there is provision for infringement of a trademark.

- ***Geographical Indications:*** Geographical indications are place, names used to identify the origin and quality, reputation or other characteristics of products. The examples usually are "Champagne", "Tequila" or "Roquefort". However, countries such as India would like "Kanjivaram Saree" and perhaps even "Mysore Dosa" to become standard examples.

  Protection required under the TRIPS Agreement is defined in two Articles. All products are covered by Article 22, which defines a standard level of protection. This says that geographical indications have to be protected in order to avoid misleading the public and to prevent unfair competition.

  The protection being provided exclusively under Article 23 for wines and spirits is unfortunately not available to several products from the developing world.

- ***Layout Designs (Topographies) of Integrated Circuits:*** With regard to the treaty on intellectual property in respect of Integrated Circuits (IPIC Treaty), members agreed to

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provide protection to the layout-designs (topographies) of integrated circuits (referred in the WTO Agreement as "layout-designs".

In the event of trading in an integrated circuit incorporating an unlawfully reproduced layout design or any article incorporating such an integrated circuit, the person concerned, upon being informed of such an act, shall pay the "holder a sum equivalent to a reasonable royalty such as would be payable under a freely negotiated license in respect of such a layout design".

Caution Copying or reproducing any published or copyrighted work of literary or artistic nature is illegitimate and is punishable by law.

8.1.8 Indian IC Layout Design Act

The Semi-conductor Integrated Circuits Layout Design Act, 2000, which received Presidential assent in September 2000, among other things, mentions the following:

"Layout Design" means a layout of transistors and other circuitry elements and included lead wires connecting such elements and expressed in any manner in a semiconductor circuit.

"Semiconductor Integrated Circuit" means a product having transistors and other circuitry elements which are inseparably formed on semi-conductor material or on insulating material or inside semi-conductor material and designed to perform an electronic circuitry function.

The Act disallows registration for IC layout design that:

1. is not original; or
2. has been commercially exploited anywhere in India or in a convention country; or
3. is not inherently distinctive; or
4. is not inherently distinguishable from any other registered layout design.

The registration of a layout design is for a period of 10 years from the date of filling of an application for registration or from the date of first commercial exploitation anywhere in India or any country, whichever is earlier.

Industrial Designs: A design must satisfy the following:

1. It must be new or original, meaning that the design must have not been previously published.
2. It must relate to the features of shape.
3. It must be applied to any article by industrial process.
4. It should appeal to and be judged solely by the naked eye.

Article 25 on "Requirements for Protection" states that:

1. Members shall provide for the protection of independently created industrial designs that are new or original.
2. Each member shall ensure that requirements for securing protection for textile designs, in particular in regard to any cost, examination or publication, do not unreasonably impair the opportunity to seek and obtain such protection.

Article 26 on 'Protection' states that:

1. The owner of a protected industrial design shall have the right to prevent third parties not having the owner's consent from making, selling, selling or importing articles bearing or

embodying a design which is a copy, or substantially a copy, of the protected design, when such acts are undertaken for commercial purposes.

2. The duration of protection available shall amount to at least 10 years. (The Indian Designs Act, 2000, also provides the same protection of 10 years)

Indian Designs Act

The existing legislation on industrial designs in India is contained in the Designs Act, 2000.

Among other things, the Act mentions the following:

- ***'Article'*** means any article of manufacture and any substance, artificial, or partly artificial and partly natural and includes any part of an article being made and sold separately.
- ***'Design'*** means only the features of shape, configuration, pattern, ornament or composition of lines or colours applied to any article whether in two dimensional or three dimensional or in both forms, by any industrial process or means, whether manual, mechanical, or chemical, separate or combined, which in the finished article appeal to and are judged solely by the eye.
- ***"Prohibition of Registration of Certain Designs"***

  A design will not be registered:

  - If it is not new or original; or
  - If it has been disclosed to the public anywhere in India or in any other country by publication in any tangible form or by use or in any other way prior to the filing date; or
  - If it is not significantly distinguishable from known designs or combination of known designs; or
  - If it comprises or contains scandalous or obscene material.

  The copyright of a registered design will extend for 10 years from the date of registration, extendable on an application from the registered proprietor for a second period of five years from the expiration of the original period.

TRIPS and Control of Anti-competitive Practices: Under Section 8 regarding 'Control of Anti-competitive practices in Commercial Licenses' there is recognition "that some licensing practices or conditions pertaining to intellectual property rights which restrain competition may have adverse effects on trade and may impede the transfer and dimension of technology".

Thus members are allowed to specify in their legislation licensing practices or conditions that may in particular cases constitute an abuse of intellectual property rights having an adverse effect on competition in the relevant market.

Sanitary and Phytosanitary (SPS) Agreement

The Agreement on the Application of Sanitary and Phytosanitary Measures - also known as the SPS Agreement was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade, and entered into force with the establishment of the WTO at the beginning of 1995.

Under the SPS agreement, the WTO sets constraints on members' policies relating to food safety (bacterial contaminants, pesticides, inspection and labelling) as well as animal and plant health (imported pests and diseases).

SPS & Genetically Modified Organisms (GMOs): In 2003, the United States challenged a number of EU laws restricting the importation of Genetically Modified Organisms (GMOs), arguing they

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are "unjustifiable" and illegal under SPS agreement. In May 2006, the WTO's dispute resolution panel issued a complex ruling which took issue with some aspects of the EU's regulation of GMOs, but dismissed many of the claims made by the U.S.

Criticism: Quarantine policies play an important role in ensuring the protection of human, animal and plant health. Yet under the SPS agreement, quarantine barriers can be a 'technical trade barrier' used to keep out foreign competitors.

The SPS agreement gives the WTO the power to override a country's use of the precautionary principle – a principle which allows them to act on the side of caution if there is no scientific certainty about potential threats to human health and the environment. In *EC measures Concerning Meat and Meat Products (Hormones)* WT/DS/26/AB/R the Appellate Body of the WTO held that it was "less than clear" whether the precautionary principle had crystallized into a principle of customary international law, (EC-Hormones paragraph 123) and even if it had, it could not override the provisions of Articles 5.1 and 5.2 of the Agreement on the Application of Sanitary and Phytosanitary Measures (SPS Agreement) that require members to base their measures on a risk assessment. (EC-Hormones paragraphs 123, 124 and 125. See discussion K Kennedy "Resolving International Sanitary and Phytosanitary Disputes in the WTO: Lessons and Future Directions" (2000) Volume 55 Food and Drug Law Journal 81 at 95) The Appellate Body also pointed out that the principle had not been written into the SPS Agreement, although the Appellate Body conceded that the principle was reflected in the sixth paragraph of the preamble of the SPSA, as well as articles 3.3 and 5.7.(EC-Hormones paragraph 124) Article 3.3 allows members to implement quarantine measures higher than those found in international standards, as long as the measures otherwise comply with the SPS Agreement; while Article 5.7 allows provisional measures where there is insufficient scientific evidence. Additionally, the Appellate Body acknowledged that article 5.7 does not necessarily exhaust the relevance of the precautionary principle and that, where there are risks of irreversible damage, governments often act from the point of view of prudence. (EC-Hormones paragraph 124)

Under SPS rules, the burden of proof is on countries to demonstrate scientifically that something is dangerous before it can be regulated, even though scientists agree that it is impossible to predict all forms of damage posed by insects or pest plants.

Task Analyse the Berne Convention.

8.1.9 Agreement on Trade Related Investments Measures (TRIMs)

The Agreement on Trade Related Investment Measures (the 'TRIMs Agreement') applies to investment measures related to trade in goods only. The Agreement restrains members from applying any investment measure that is inconsistent with the provisions of Article III (National Treatment on Internal Taxation and Regulation) or Article XI (General Elimination of Quantitative Restrictions) of the GATT 1994. The Agreement carries an illustrative list of trade related investment measures that are inconsistent with the obligation of national treatment provided for in Paragraph 4 of Article III and the obligation of general elimination of quantitative restrictions provided for in Paragraph I of Article XI of GATT 1994.

TRIMS Inconsistent

1. TRIMS that are inconsistent with the obligation of national treatment provided for in Paragraph 4 of Article III include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, and which require

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(a) the purchase or use by an enterprise of products of domestic origin, or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production ("Local Content Requirements"); or

(b) that an enterprise's purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports.

2. TRIMs that are inconsistent with the obligation of general elimination of quantitative restrictions provided for in Paragraph I of Article XI of GATT 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage and which restrict:

(a) the importation by an enterprise of products used in or related to its local production, generally or to an amount related to the volume or value of local production that it exports ("Trade Balancing Requirements");

(b) the importation by an enterprise of products used in or related to its local production by restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise ("Foreign Exchange Balancing Requirements"); or

(c) the exportation or sale for export by an enterprise of products, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production ("Export Performance Requirements").

Developing Country Members: Members categorized as developing countries are given special concessions. A developing country members facing balance of payment problems can deviate, temporarily though from the provisions of Articles III and XI of the GATT 1994.

Withdrawal of Measure: Members were required to follow a specified timetable for withdrawal of measures that were not compatible with TRIMS:

1. ***Developed country member:*** Within two years of the date of entry into force of the WTO Agreement, that is within January 1997.

2. ***Developing country member:*** Within five years of the date of entry into force of the WTO Agreement, that is within January 2000.

3. ***Least-developed country member:*** Within seven years of the date of entry into force of the WTO Agreement, that is within January 2002.

However the Council for Trade in Goods (CTG) was given the option to extend the transition period for the elimination of TRIMs for developing country and least-developed country members demonstrating particular difficulties in implementing the provisions of the Agreement. The CTG when considering such a request was required to take into account the individual development, financial and trade needs of the members making the request.

Apart from the above allowance given to developing country and LCD members, the Agreement took into consideration situations where an established enterprise subject to a TRIM notification had to meet new competition during the transition period.

Given such a condition, any member, developed or developing, could apply the same TRIM to the new investment (i) where the products of such investment were like products to those of the established enterprises and (ii) where necessary to avoid distorting the conditions of competition between the new investment and the established enterprises. Such a new measure had to be notified to the CTG with the date of termination being the same for both the old and new members.

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Agreement on Technical Barriers to Trade (TBT)

The Agreement on Technical Barriers to Trade - also known as the TBT Agreement is an international treaty of the World Trade Organization. It was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade, and entered into force with the establishment of the WTO at the end of 1994.

The object of the TBT Agreement is "to ensure that technical negotiations and standards, as well as testing and certification procedures, do not create unnecessary obstacles to trade".

Caselet

African Individual

Economist Andre Nijsen uses the example of Tanzania, in Africa, to show how an usable set of export policies can be adopted. In the 1990s, this poor, African state sought to triple its exports and imitate the success of the East Asian States. The basic Tanzanian policy was to first identify the country's strengths. In this case, it was plentiful natural resources such as minerals usable in the global industry. The government intervenes, creating the incentive structure important to development. The government would make it easier in every way to shift production to the export market, even underwriting new industries. The legal, regulatory and judicial sectors were overhauled, and the infrastructure of the country was targeted for investment and improvement. While the program was only a partial success—largely due to public sector failures – the basic pillars of this reform remain sound.

Source: http://www.ehow.com/info_7779251_export-development.html

8.2 General Agreement on Tariffs and Trade (GATT)

The General Agreement on Tariffs and Trade (typically abbreviated GATT) was originally created by the Breton Woods Conference as part of a larger plan for economic recovery after World War II. The GATT's main purpose was to reduce barriers to international trade. This was achieved through the reduction of tariff barriers, quantitative restrictions and subsidies on trade through a series of different agreements. The GATT was an agreement, not an organization. Originally, the GATT was supposed to become a full international organization like the World Bank or IMF called the International Trade Organization. However, the agreement was not ratified, so the GATT remained simply an agreement. The functions of the GATT have been replaced by the World Trade Organization which was established through the final round of negotiations in the early 1990s.

The history of the GATT can be divided into three phases: the first, from 1947 until the Torquay round, largely concerned which commodities would be covered by the agreement and freezing existing tariff levels. A second phase, encompassing three rounds, from 1959 to 1979, focused on reducing tariffs. The third phase, consisting only of the Uruguay Round from 1986 to 1994, extended the agreement fully to new areas such as intellectual property, services, capital, and agriculture. Out of this round the WTO was born.

GATT 1947

The first version of GATT, developed in 1947 during the United Nations Conference on Trade and Employment in Havana, Cuba, is referred to as "GATT 1947". On January 1, 1948 the agreement was signed by 23 countries: Australia, Belgium, Brazil, Burma, Canada, Ceylon, Chile, the Republic of China, Cuba, the Czechoslovak Republic, France, India, Lebanon, Luxembourg, Netherlands, New Zealand, Norway, Pakistan, Southern Rhodesia, Syria, South Africa, the

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United Kingdom, and the United States. 45,000 tariff concessions were made influencing over $10 billion in trade which comprised 20% of the total global market at the time.

GATT 1947 in the US

The GATT, as an international agreement, is similar to a treaty. Under United States law it is classified as a congressional-executive agreement. Based on the Reciprocal Trade Agreements Act it allowed the executive branch negotiating power over trade agreements with temporary authority from Congress. At the time it functioned as a provisional, but promising trade system. The agreement is based on the "*unconditional most favoured nation principle*." This means that the conditions applied to the most favoured trading nation (i.e. the one with the least restrictions) apply to all trading nations. In the US, there was large opposition against the International Trade Organization (which had been ratified in several countries, including Australia), and thus President Truman never even submitted it to Congress. This caused other countries to lose interest and left the orphaned GATT as the world's only multilateral trade agreement, coming into force on January 1, 1948.

GATT 1949

The second round took place in 1949 in Annecy, France. The main focus of the talks was more tariff reductions, around 5000 total.

GATT 1951

The third round occurred in Torquay, England in 1951. 8,700 tariff concessions were made totaling the remaining amount of tariffs to three-fourths of the tariffs which were in effect in 1948.

GATT 1955-1956

The fourth round returned to Geneva in 1955 and lasted until May 1956. $2.5 billion in tariffs were eliminated or reduced.

GATT "Dillon" 1960-1962

The fifth round occurred once more in Geneva and lasted from 1960 to 1962. The talks were named after Under Secretary of State General of the US, Douglas Dillon, who first proposed the talks. Along with reducing over $4.9 billion in tariffs, it also yielded discussion relating to the creation of the European Economic Community (EEC).

GATT "Kennedy" 1964-1967

The sixth round was the last to take place in Geneva from 1964 until 1967 and was named after the late US President Kennedy in his memory. Concessions were made on $40 billion worth of tariffs. Some of the GATT negotiation rules were also more clearly defined.

GATT 1973-1979

The seventh round of GATT took place in Tokyo from 1973 until 1979. The talks managed to reduce several trade barriers in addition to $300 billion in tariffs. Negotiations covered a range of topics including government procurement, customs valuation, subsidies, countervailing measures, antidumping, standards and import licensing.

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GATT and the World Trade Organization

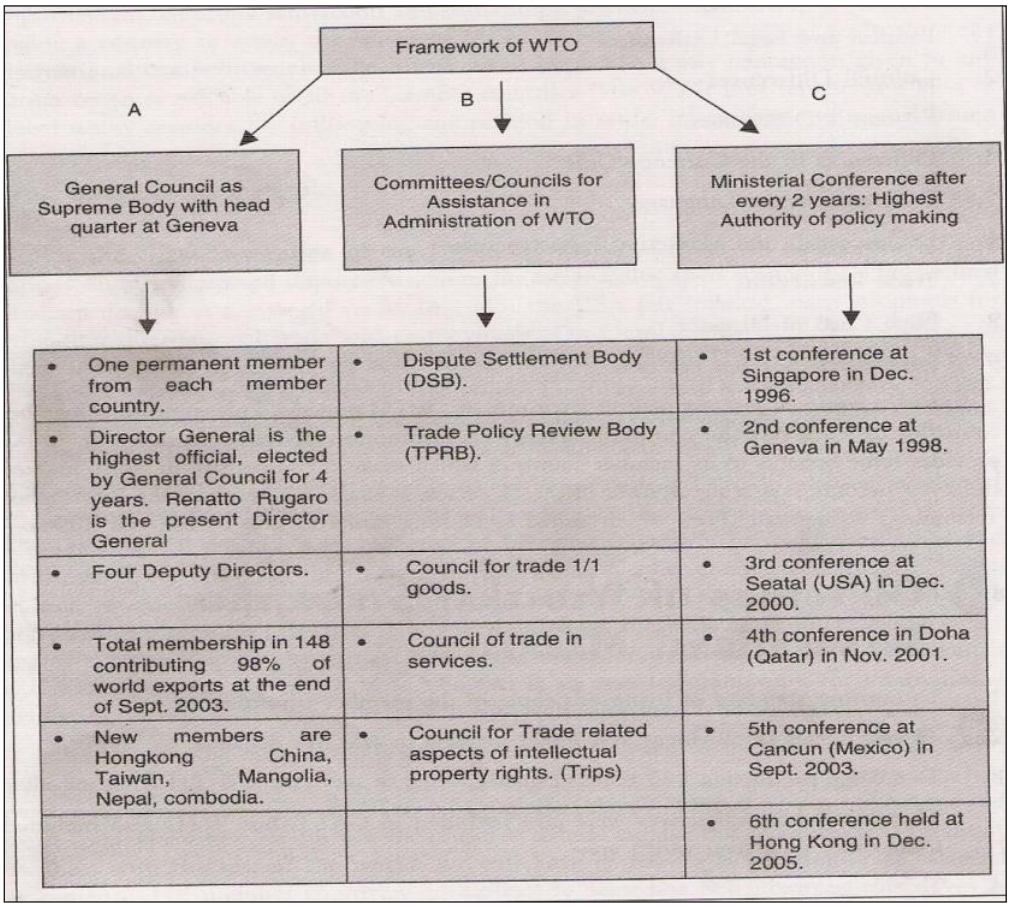
In 1994 the GATT was updated (*GATT 1994*) to include new obligations upon its signatories. One of the most significant changes was the creation of the World Trade Organization (WTO). The 75 existing GATT members and the European Communities became the founding members of the WTO on January 1, 1995. The other 52 GATT members rejoined the WTO in the following two years (the last being Congo in 1997). Since the founding of the WTO, 21 new non-GATT members have joined and 28 are currently negotiating membership.

Of the original GATT members, only the SFR Yugoslavia has not rejoined the WTO. Since FR Yugoslavia, (renamed to Serbia and Montenegro and with membership negotiations later split in two), is not recognised as a direct SFRY successor state; therefore, its application is considered a new (non-GATT) one. The contracting parties who founded the WTO ended official agreement of the "GATT 1947" terms on December 31, 1995.

Whereas GATT was a set of rules agreed upon by nations, the WTO is an institutional body. The WTO expanded its scope from traded goods to trade within the service sector and intellectual property rights. Although it was designed to serve multilateral agreements, during several rounds of GATT negotiations (particularly the Tokyo Round) plurilateral agreements created selective trading and caused fragmentation among members. WTO arrangements are generally a multilateral agreement settlement mechanism of GATT.

8.3 Establishment of World Trade Organization

The administrative framework of WTO is shown in the given chart:



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8.4 The Uruguay Round Package: Organization Structure of the WTO

The Uruguay Round began in 1986. It was the most ambitious round to date, hoping to expand the competence of the GATT to important new areas such as services, capital, intellectual property, and agriculture.

Agriculture was essentially exempted from previous agreements as it was given special status in the areas of import quotas and export subsidies, with only mild caveats. However, by the time of the Uruguay round, many countries considered the exception of agriculture to be sufficiently glaring that they refused to sign a new deal without some movement on agricultural products. These fourteen countries came to be known as the "Cairns Group", and included mostly small and medium sized agricultural exporters such as Australia, Brazil, Canada, Indonesia, and New Zealand.

8.5 WTO – The Third Pillar in the Global Business

The third pillar of WTO policies that negatively affect developing countries is the whole issue of tariffs. When the developing countries signed on to the Agreement in Agriculture, they were assured of market access for their agricultural products in developed countries. But because of tariff peaks and tariff escalations—and in spite of developed countries having fulfilled their commitments on tariff reductions—market access has not been achieved. In the coming round of negotiations, this will remain one major issue: how to ensure actual tariff reductions and do away with tariff peaks and tariff escalations, so that products of export interest to developing countries can gain entry to developed-country markets.

The fourth pillar is like an invisible pillar. Tariffs are very often known to exporters who can perhaps plan accordingly. But non-tariff barriers, in the WTO parlance, have affected developing-country exports even more negatively than tariffs. Each non-tariff barrier could be the focus of a lot of discussion. But suffice it to say that a lot of these non-tariff barriers go against the very grain of the public pronouncements that these countries make about globalization and liberalization, as well as against the context of a new round. It is exactly these non-tariff barriers that are limiting exports from developing countries.

Irrespective of the kind of policies that a lot of northern countries are following, domestic agricultural production and rural incomes do fall in developing countries. And when rural incomes fall and there is a shift away from the traditional agricultural systems, we have reduced access to food. That, in turn, leads to migration from the rural areas.

Notes In 1994 the GATT was updated (*GATT 1994*) to include new obligations upon its signatories. One of the most significant changes was the creation of the World Trade Organization (WTO)

Did u know? WTO was founded on 1st January, 1995.

Self Assessment

Fill in the blanks:

11. Council acts on behalf on the ……. on all of the WTO affairs.
12. ……. is generally by consensus and relative market size is the primary of bargaining power.

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13. Third conference in Seattle, Washington in ……...…….
14. Sixth WTO Conference Ministerial was held in Hong Kong From …….
15. The third pillar of WTO policies that negatively affect developing countries is the whole issue of ……...

Case Study **Business in China**

From 1949 to 1979 China had a nearly autarkic economy and prohibited foreign investment and restricted foreign trade. Although its brand of communism stressed isolationism, China's policy also reflected its historical belief that contact with foreigners tended to corrupt its politics and harm its culture. However, fearing that it was falling farther behind other countries economically, China enacted the Law on Joint Ventures using Chinese and Foreign Investment in 1979. Since then, China has experienced a dramatic rise in FDI. It has become the largest recipient of FDI among all developing countries, and since 1993, it has ranked second to the United States for FDI inflows among all countries. By mid-2002, total FDI in China had exceeded $700 billion and was invested in nearly 400,000 ventures. Japan, Taiwan, and the United States are China's most important sources of FDI.

While China steadily adopted the principles of free trade, it modified its practical aspects. As a rule, China restricted imports and foreign companies found FDI to be a more realistic way to serve the Chinese market. Moreover, while China let foreign investors propose their preferred mode of entry, it applied stringent criteria through an extensive review process. Specifically, the Chinese Ministry of Foreign Trade and Economic Cooperation (MOFTEC) or provincial-level authorities with jurisdiction over certain types of investments reviewed each foreign investment application to determine whether the investment was in the best interest of China—i.e., whether it helped capital formation, promoted exports, created jobs or transferred technology. Chinese officials negotiated with each potential investor to try to improve its potential contributions. The Chinese rejected many proposals that offered insufficient benefits. Foreign companies would endure protracted negotiations (often spanning several years) with Chinese companies and provincial authorities before presenting an application to MOFTEC. The growth of FDI in China in the face of the laborious entry process testified to companies' desire to operate in China. Multinational Enterprises MNEs coveted China's market for several reasons, including:

1. ***Market potential:*** China has about 1.3 billion inhabitants. A Monsanto spokesperson summed up this allure by stating, "You just can't look at a market that size and not believe that eventually a lot of goods are going to be sold there. One aspirin tablet a day to each of those guys, and that is a lot of aspirin."
2. ***Market performance:*** China's purchasing power has been increasing because of its strong economic growth. This growth has translated into the consumer spending on necessity and luxury products. Economists project that China will soon be the largest economy in the world as measured by its purchasing power.
3. ***Infrastructure:*** China is in the process of spending more than $1 trillion on infrastructure projects, including dams, power plants, subway systems, highways and railroads.
4. ***Resources:*** China has an immense pool of inexpensive and productive labour as well as rich supplies of petroleum and minerals.

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5. ***Strategic positioning:*** Many companies see investment in China as a crucial part of a global strategy, particularly given its status as the world's final big growth market. Explained one analyst, "If you want to survive, you have to be global, and China is a part of the global economy."

Over time, the Chinese government has encouraged foreign investment—albeit only in certain sectors of the economy and only subject to evolving constraints. Early on, the Chinese government believed that the superior competitiveness of foreign investors would crush its fledgling domestic firms. Therefore, since the early 1980s, China has provided special Economic Zones (SEZs) that offered foreign investors preferable tax, tariff, and investment treatment as long as they exported all of their output. These incentives were necessary because the uncertainty of China's political environment made foreign companies wary about investing there.

Foreign companies could also establish joint ventures with Chinese companies to sell to the domestic market. However, the government approved these proposals only if they served a national priority for which China had to seek outside help. Chinese market-serving investments were made to improve an existing Chinese product or industry rather than to launch production of a new product in China. For example, China approved of a number of joint ventures in the petroleum industry because it considered future oil sales a high priority for earning foreign exchange.

Getting permission to operate in China required companies to follow a long and winding road that started with an expression of interest and ended with an extensive review by MOFTEC or provincial authorities. A foreign firm began by finding a Chinese organization to sponsor its application to establish a representative office. The foreign company might then be assigned a Chinese company with which it negotiated. This same Chinese company could negotiate with more than one foreign company to develop the best offer. The same steps applied to a wholly-owned investment; however, the foreign company could deal directly with all authorities rather than have a proposed partner handle the arrangements.

Determining the proper authority depended on the priority of the particular type of investment. For example, provincial officials could approve those business operations that planned to export all output. Further, MOFTEC prioritized industries—those that it encouraged, restricted, or prohibited involvement by foreign companies. The higher the priority, the more likely that approval would be granted at the provincial level. The list of industries was quite detailed and specific. For example, the list applied in 1995 included industries within 18 categories.

Until the mid-1990s, China required most foreign firms to agree to an equity joint venture with a local partner as a precondition to market access. The Chinese government believed that equity joint ventures versus other types of FDI transferred capital, technology and management skills yet did not dilute its own control. Theoretically, a foreign firm could establish a wholly foreign-owned venture in select industries. Such proposals, however, received greater scrutiny from Chinese authorities.

China has steadily increased its dependence on international business. Its trade (imports plus exports) as a percentage of GDP has risen, so too has the number of SEZs. It has gradually permitted wholly foreign-owned ventures. In 1997, such ventures surpassed equity joint ventures for the first time. By 1999, more than half of all foreign investments in China were in the form of wholly foreign-owned ventures. Further, Chinese companies could seek foreign joint venture partners on their own.

China joined the WTO in November 2001. Accession to the WTO required the Chinese government to agree to trade and investment liberalization. China's gradual integration

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into the WTO will change its economy by opening it to foreign products and firms. China must begin to accept a system of global trading rules—everything from lower tariffs to anti-dumping regulations to removal of rules restricting distribution and retailing as well as penalties for violating trademarks, patents and copyrights.

There are benefits and costs to joining the WTO. Regarding the former, some forecast that China could double its exports by 2005, gain an extra percentage point of economic growth for the next decade, and double its FDI stock within the next five years. Regarding drawbacks, WTO membership requires the Chinese government to reform many business institutions and market practices. Some Chinese oppose such changes. For example, five independent bombings hit the operations of Western multinationals that were patronized by affluent Chinese, such as McDonald's, right after China joined the WTO.

Foreign firms welcome the changes required by the WTO. Foreign-invested enterprises make nearly half of all China's exports and three-quarters of its manufactured goods. A boost in exports directly benefits these firms. Operationally, WTO regulations give foreign firms the option to set up wholesale, retail, distribution, and after-sale networks in China. Similarly, foreign firms no longer must comply with local content requirements, deal with the previously high tariffs on imports, or submit investment proposals that involve technology transfers to MOFTEC. Moreover, China has agreed that its many state-owned enterprises will not discriminate against foreigners and that commercial considerations must apply when purchasing goods or services. Because trade and investment among WTO members must abide by a specified set of enforceable rules, the Chinese business environment should become more stable.

It remains to be seen how China interprets and enforces its WTO commitments. China joined the WTO as a developing country, thereby gaining the right to comply with WTO regulations over several years. For example, Chinese import tariffs on automobiles, which in 2002 were slashed to between 44 and 51 percent (depending on the engine size), fell to 25 percent by mid-2006. Moreover, the Chinese government's system of import quotas and licenses for automobiles did not phase out until 2006. Still, MNEs are optimistic about the wisdom of investing in China. Some noted that China's agreement when it joined the WTO reduced its political, legal, and economic risks to MNEs.

WTO membership seemed to be the latest step in China's long march towards an open market economy. This march began in the spring of 1992, when veteran leader Deng Xiaoping, during his "southern tour," reiterated China's commitment to both an open-door policy and movement to a market economy. The 15th Communist Party Congress in 1997 marked the start of a new phase of market reform with its promise to transform the country's economic and business structure. In 1998, the Communist Party removed ideological barriers to private ownership by amending the state constitution to acknowledge the private sector. In 2001, President Jiang Zemin called the Communist Party to allow entrepreneurs and business executives to join it, thereby legitimizing the idea of private enterprise. Noted one observer, this proposal "basically turns the Party on its head. It means the Party will once and for all put aside all ideological reservations towards growing a private sector in China."

The contest between market economics and ideological legacies in China will play out over many years. During this time, foreign investors will play an increasingly prominent role in a country that historically has been wary of foreigners. Indeed, large segments of Chinese society are less than enchanted by an open market economy, growing exposure to foreign cultures and increasing interdependence with other countries. This situation creates many challenges for managers. If history is any guide, the Chinese government's outlook on investments by foreign companies will largely influence success.

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Questions

1. Profile the evolution of the Chinese business environment. Does this evolution strike you as predictable or unpredictable? Why would its degree of predictability matter to foreign investors?
2. Do you think the benefits of operating in China outweigh the risks?
3. What would you advise a company to do to maximize its rewards and to limits its risks?
4. Is it reasonable to expect China to adopt and fully enforce WTO regulations, particularly regarding intellectual property rights, in the next few years? If it chooses not to do so, what options would companies have to protect their interests?
5. How do you think the contest between market economics and ideological legacies will play out in China over the next ten years?

Source: International Business Environment by Raj Kumar

8.6 Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- The effect of tariff is to raise the cost of imported products and the consumers loose because they have to pay more for imports.
- By lowering costs, subsidies help domestic producers to compete against low-cost foreign imports and to gain export markets.
- An import quota is a direct restriction imposed by an importing country on the quantity of some good that may be imported. A voluntary export restraint is a quota on trade-imposed from the exporting country's side.
- A local content requirement calls for some specific fraction of a good to be produced domestically.
- An administrative policy is an informal instrument or bureaucratic rule that can be used to restrict imports and boost exports.
- 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, 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.
- The problems with strategic trade policy are two fold: (a) such a policy may invite retaliation, in which case all will loose, and (b) strategic trade policy may be captured by special interest groups, which will distort it to their own ends.
- The GATT was a product of the post-war free trade movement. The GATT was successful in lowering trade barriers on manufactured goods and commodities. The move towards greater free trade under the GATT appeared to stimulate economic growth.
- The completion of the Uruguay Round of GATT talks and 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.
- The theory of economic integration refers to the commercial policy of discriminatively reducing or eliminating trade barriers only among the nations joining together.

Notes

8.7 Keywords

General Agreements 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.

Layout Design: It means a layout of transistors and other circuitry elements and included lead wires connecting such elements and expressed in any manner in a semiconductor circuit.

Non-tariff barriers: Non-tariff barriers are restrictions arising from measures such as licensing, product testing, certifications, procedural hurdles, etc.

Quota restrictions: Quota restrictions mean explicit limit (usually measured by volume or sometime by value on the amount of a particular product that can be imported or exported during a specified time period.

Semi-conductor Integrated Circuit: It means a product having transistors and other circuitry elements which are inseparably formed on semiconductor material or on insulating material or inside semiconductor material and designed to perform an electronic circuitry function.

Tariff Barriers: Tariffs were originally intended to raise revenues for the government. However, they are now commonly used as a form of protectionism-to restrict imports to protect domestic industry or to restrict exports to preserve national endowments.

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.

8.8 Review Questions

1. What do you understood by Trade Blocks? Explain the purpose and various types of trading blocks.
2. Whose interests should be the paramount concern of government trade policy-the interests of the producers (businesses and their employees) or those of consumers?
3. Describe the organization structure of WTO. Explain WTO's role in liberalization of global trade in goods and services.
4. What do the terms "Observer Governments" and "WTO Accession" means?
5. Describe the limitation of GATT and how Dunkel's proposals led to the formation of WTO.
6. "WTO is the third pillar in the global business." Comment.
7. Analyse the role of India in WTO.
8. Discuss how the MFN clause resulted in dumping and the anti-dumping measures imposed by member countries.
9. Can you describe WTO: what it is and what it does?
10. Write a short note on Trade-related Aspects of Intellectual Property Rights (TRIPs) Agreement.

Answers: Self Assessment

1.	WTO	2.	Trade work
3.	Predictability	4.	Nations
5.	welfare	6.	Fourth Ministerial Conference
7.	conference	8.	One country, one vote

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9. Trade Policy Review Body and Despite Settlement Body
10. General Council
11. Ministerial Council
12. Decision-making
13. 1999
14. December 13–December 18, 2005
15. tariffs

8.9 Further Readings

Book

Krishna Rao, Palle WTO Text & Cases, PSG-Excel Series, Excel Books 2005, New Delhi.

Online links

http://www.wto.org/english/thewto_e/whatis_e/tif_e/understanding_e.pdf

http://www.wto.org/english/res_e/doload_e/10b_e.pdf

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Unit 9: International Financial Institutions-I

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Objectives

After studying this unit, you should be able to:

- Describe the financial environment
- Discuss the IMF and World Bank
- Explain the role of financial institutions

Introduction

At a country level, the Trade Finance Programme is frequently invited to carry out diagnosis of the local financial environment in order to identify areas of improvement or to introduce measures and financial schemes supporting entrepreneurs in their efforts to trade internationally.

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The financial environment comprises all public sector institutions, official organizations, monetary, financial, fiscal and legal authorities involved directly or indirectly with finance issues and that have a direct impact on the availability and cost of trade finance. Special incentive schemes, training institutes for bankers, auditing firms and all the providers of services that support trade finance, are part of this environment.

Usually, requests for technical assistance at this level are formulated by local authorities concerned with international trade expansion and sometimes by regional banks. In many instances they are part of an integrated effort supported by several donors and UNDP.

Activities at this level can be simply of an advisory nature or more involved such as implementing measures or schemes identified in partnership with local institutions and authorities. Examples of diagnostic tools developed by ITC at the financial environment level are country "snapshots" that will soon lead to complete Trade Finance Maps which are currently being developed and tested.

During the period of World War II (1939-1945), it was realized that the economic development of all the countries of the world was the only solution to attain stable peace and prosperity in the world. It was felt by the developed nations that poverty anywhere is a threat to prosperity everywhere. As a result in the year 1944, a conference was held at Bretton Woods in USA which was attended by the representatives of 44 countries including India. It was decided in the conference of Bretton Woods to set up two financial institutions for the development of all countries of the world. These two institutions were:

1. International Monetary Fund (IMF); and
2. International Bank for Reconstruction and Development (IBRD) popularly known as World Bank.

The logic behind setting up IMF was to stabilize exchange rates by facilitating the removal of temporary balance of payments deficits. The objective of IBRD or World Bank was to reconstruct the war-ravaged economies and provide them the capital necessary for the economic development of underdeveloped countries. A detailed description of these institutions is given in this unit. For the promotion of world trade, an agreement related to tariffs on trade was signed by a few countries of the world on October 30, 1947; this agreement was known as GATT which was replaced by World Trade Organization (WTO), in 1995.

Did u know? IMF was setup to stabilise exchange rates and IBRD was setup to provide aid to economically weaker countries.

9.1 International Financial Institutions and Liquidity

The Financial Institutions Practice Group represents domestic and foreign financial institutions, their holding companies and affiliates and major non-bank financial companies encompassing the entire scope of permissible bank and non-bank activities. Such activities have included bank and commercial lending, secured and unsecured lending; asset based lending, leasing, project finance, structured finance, asset securitization, debt and equity securities offerings, trust services and regulatory counseling and representation before federal and state agencies. We also represent non-financial corporate clients in all of their lending and borrowing requirements, including unsecured and asset based lending, leasing and securitized transactions.

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9.2 International Monetary Fund (IMF)

9.2.1 Background

A landmark in the history of world economic co-operation is the creation of International Monetary Fund, briefly called IMF. The establishment of an International Monetary Fund was the outcome of a conference held at Bretton Woods (U.S.A.) in 1944. The conference gave birth to the IMF organization along with IBRD.

The IMF came into existence in December 1945, and it announced its readiness to commence exchange transactions in March 1947. At present, the IMF has 187 countries as its members. The IMF is a pool of central bank reserves and national currencies which are available to its members under certain conditions. It can be regarded as an extension of the central bank reserves of the member countries.

9.2.2 Objectives of IMF

The main purposes setting up of IMF are:

1. ***Creation of international monetary co-operation:*** The first and foremost objective of the fund is to promote international monetary cooperation through a permanent institution.
2. ***Promotion of balanced growth of International Trade:*** The second important objective of the fund is to facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high levels of employment of the member countries.
3. ***Stability in exchange rate:*** One of the main objectives of IMF is to promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.
4. ***Multilateral Payments Arrangement:*** This objective is to assist in the establishment of a multilateral system of payment in respect of current account transactions between members and in the elimination of foreign exchange restrictions, which hamper the growth of world trade.
5. ***To correct maladjustments in the balance of payments:*** The important objective is to give confidence to members by making the fund's resources available to them under adequate safeguards. Thus, it provides them with an opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national and international prosperity. The IMF does not interfere in the internal economy of the member countries in order to restore equilibrium in their balance of payments.
6. ***To shorten the duration and lessen the degree of disequilibrium:*** The objective is to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.
7. ***Abolition of exchange restrictions:*** The fund will try to remove all sorts of restrictions and controls on foreign exchange imposed by the member countries.
8. ***Help in international payments:*** The fund will lend or sell to its member nations currencies of other countries. This facilitates foreign exchange transactions among the members.
9. ***Aid to member countries during emergency:*** The fund aims at providing short-term monetary assistance to member nations during emergency.

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Notes The IMF came into existence in December 1945, and it announced its readiness to commence exchange transactions in March 1947

Membership of IMF

There are two types of members of the fund:

1. ***Original Members:*** All those countries whose representatives took part in Bretton Woods Conference and who agreed to be the member of the Fund prior to 31st December, 1945, are called the original members of the Fund.
2. ***Ordinary Members:*** All those who became its member subsequently are called ordinary members.

Any country can cease to be its member after giving a notice in writing to that effect. Fund can terminate the membership of such a country which does not observe its rules. The number of member-countries from 40, in 1947, has risen to 187 countries in 2010.

Organization and Management

In order to manage the fund, the following administrative boards have been set up:

1. ***Board of Governors:*** It consists of one Governor and an Alternate Governor for each member country. It meets once a year. The board of governors frames the policies of the Fund.
2. ***Board of Directors:*** It conducts day-to-day affairs of the Fund. It consists of 21 directors, 7 of whom are permanent and others being temporary directors. Permanent directors belong to those countries that have the largest quotas in the Fund. Currently, these countries are United States, Japan, Germany, France, China, Italy and Saudi Arabia. Fourteen other directors are elected by other member countries. India is one of the elected directors. The managing director may appoint three deputy managing directors instead of one, w.e.f. June, 1994.

Capital Resources of the Fund

The capital resources of the fund are subscribed by the various member-countries by way of their respective quotas. Each member's quota is determined before its enrolment as a member. The quota of each member is fixed in terms of SDRs. Each country has to give 25% of its quota amount in terms of reserve assets, like SDRs or any other usable currency and 75 per cent in terms of its own currency. A country's relations with the fund are determined by the amount of its quota.

Example: (a) Voting powers of a member-country depends upon the amount of its quota. Each country has 250 minimum votes. Besides, on each lakh of SDRs, one vote is increased. (b) The maximum limit of the financial assistance from the Fund to the member country to correct its balance of payments depends on the amount of its quota. (c) Share of a country in the allocation of SDRs depends on the amount of its quota.

Changes in the amount of quota of Fund are made after every five years. The fund has made changes in the quotas of member-countries at different times. In 2010, the quota raised by the Fund was approximately 238.4 billion SDRs. Three things are clear from the quota of a member country:

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1. The share of a member country in the capital of the fund.
2. Loan a member-country can receive from the fund.
3. The total number of votes that a member-country can cast.
4. America has the maximum quota. It constitutes 17.7 per cent of the total capital of the fund. As of end-August 2009, IMF's total quotas stood at SDR 217.4 billion (about US $325 billion).

Caution Neglection of IMF membership regulations and rules can result in determination of membership with immediate effect.

9.3 Operational Strategy of the Fund

9.3.1 Borrowing Strategy of the Fund

The Fund is an important financial institution besides performing regulatory and consultative functions. The Fund's bulk financial resources come in the form of quota subscriptions from member countries. Further, it can borrow from governments, central banks or private institutions of industrialized countries, the Bank for International Settlements and even from OPEC countries, like Saudi Arabia.

General Arrangements to Borrow (GAB)

The Fund can borrow from its 20 industrialized members under GAB and NAB (New Arrangements to Borrow) The GAB and NAB are credit arrangements between the IMF and a group of members and institutions to provide supplementary resources of up to SDR 34 billion (about US$50 billion) to the IMF to forestall or cope with an impairment of the international monetary system or to deal with an exceptional situation that poses a threat to the stability of that system.

9.3.2 Lending Strategy of the Fund

Under tranche policies, members may use the reserve tranche and the four credit tranches and three permanent facilities for specific purposes. The facility for compensatory financing of export fluctuations (established in 1963 and liberalized in 1975 and 1979), the Buffer stock financing facility (established in 1969), and the Extended Fund 'facility (established in 1974) and the Structural Adjustment Facility (SAF) established in March, 1986 – can be accessed by the members. Lending by the Fund is made to members temporarily in disequilibrium in their balance of payments on current accounts. If the currency of the member country falls below than its quota, the difference is called reserve tranche. It can draw up to 25 per cent on its reserve tranche automatically upon representation to the Fund for its balance needs. The Fund does not charge any interest on such drawings. The borrowing is to be repaid by the borrowing country within a period of 3 to 5 years.

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Caselet

Suzlon Energy: Financing Problems

The primary objective of the case is to deal with the problems encountered by Suzlon Energy Ltd., due to the liquidity crisis that surfaced in the company in the year 2008. Suzlon started as a very small company to provide alternate source of energy to the textile company of the founder, Tulsi R.Tanti. With in no time, it evolved as the world's fifth largest manufacturer of wind turbines. However, the company faced several problems in the year 2008 due to over leveraging, increased costs involved in replacing the faulty blades that it supplied to its US and Portugal clients and slow down in sales due to the global financial downturn. The liquidity crisis was further compounded by the acquisition commitments for stake in RE power. Suzlon is looking at various financing options to meet its commitments. Given these pressures, what are the different alternative finance sources, which Suzlon can tap in order to come out of the liquidity crisis?

Source: http://www.ibscdc.org/Case_Studies/Finance,%20Accounting%20and%20Control/Finance/FM0007.htm

Self Assessment

Fill in the blanks:

1. The ..... came into existence in December 1945, and it announced its readiness to commence exchange transactions in March 1947.
2. At present, the IMF has ..... countries as its members.
3. The IMF is a pool of central bank reserves and ..... which are available to its members under certain conditions.
4. Under ....., members may use the reserve tranche and the four credit tranches and three permanent facilities for specific purposes.
5. Changes in the amount of quota of Fund are made after every ..... years.

9.3.3 Credit Strategy of the Fund

Credit Tranches

Further, a member country can draw up to 100% of balance quota in installments from credit tranches. The borrowing member has to satisfy the Fund that the viable programme is being adopted to ensure financial stability. It means the drawings from credit tranches are conditional. The Fund has gradually raised the limit of borrowing by members to meet the severe balance of payment problems. Now a member can borrow up to 300 per cent of their new quotas on the total net use of the Fund's resources. Drawings made under CCFF, BSAF, SAF, STF and ESAF are excluded from this limit of 300 per cent.

Other Credit Facilities

Several new credit facilities have been created by the Fund since 1960. These credit facilities are exclusive of borrowing made under credit tranches and these loans are available for a long period of time. These credit facilities are:

1. ***Buffer Stock Financing Facility (BSFF):*** It was created in 1969. It was created for financing the commodity buffer stock by member countries. A member can draw up to 30 per cent

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of its quota under this head. The member has to cooperate with the Fund in establishing prices of commodities within the country. Repurchases are made between 3 ¼ years and 5 years.

2. ***Extended Fund Facility (EFF):*** The facility was created in 1974. The credit under EFF is provided to meet the balance of payments deficits. The amounts provided under EFF are larger than member's quota under normal credit facilities. This facility is provided for a maximum period of 10 years. The amount of loan under EFF is allowed up to 300 per cent of member's quota. The sanction is based on performance criteria and drawings installments.

3. ***Supplementary Financing Facility (SFF):*** In 1977, another facility called SFF was created to provide supplementary financing under extended or stand-by arrangements. The main purpose of SFF was to provide funds to member countries to meet serious balance of payments deficits which are large in relation to their economies and their quotas. This facility was extended to low income developing member countries also. The Fund established a Subsidy Account in 1980 to reduce the cost of borrowing under SFF to such low income developing countries. Subsidy Account means an account through which Fund makes subsidy payment to borrower countries.

4. ***Structural Adjustment Facility (SAF):*** It was established in March 1986. The main purpose of SAF was to provide concessions to carry out medium term macro-economic and structural adjustment programmes. The loans are also granted to them to solve their balance of payments problems. The loans are made available to the poorer countries on highly concessional terms. The rate of interest charged from them ranges between 0.5 to 1 per cent and the repayment period varies between 5 ½ to 10 years with a 5 year grace period. Disbursements are made on annual basis and are linked to the approval of annual arrangements with members receiving equivalent to 15% of their quota under the first, 20% under the second and 15% under the third annual arrangements. The SAF was created with the resources of SDR 2.7 billion. The resources came mainly from repayments on loans from the Trust Fund.

5. ***Enhanced Structural Adjustment Facility (ESAF):*** The ESAF was created in December 1987 with SDR 6 billion of resources. It was created to meet the medium-term financing needs of low income countries. The ESAF has same objectives, eligibility and basic programmes as are of SAF. The only difference among both is of the amount of assistance. The members can receive up to 100 per cent of Quota over a 3 year programme period, with a provision for up to 250 per cent in exceptional circumstances. Disbursements under the ESAF are biannual instead of annual.

6. ***Compensatory and Contingency Financing Facility (CCFF):*** The CCFF was created in August 1988. The main purpose of it was to provide timely compensation for temporary shortfalls or increase in cereal import costs due to factors beyond the control of the members. This facility was provided to a member to maintain the momentum of Fund-supported adjustment programmes. In 1990, the Fund introduced an important element temporarily to help members to come out of Gulf War Crisis. This was within 95 per cent of quota for CCFF. It was also decided to expand the coverage of CCFF. Now, for the calculation of export shortfalls, workers' remittances and travel receipts, shortfalls in other services such as receipts from pipelines, canals, shipping, transportation, construction and insurance, etc., have also been included under compensatory financing.

7. ***Systematic Transformation Facility (STF):*** In April, 1993, STF was established with $6 billion to help Russia and other Central Asian Republics to face balance of payments crisis.

8. ***Emergency Structural Adjustment Loans (ESAL):*** ESAL facility was established in early 1999 by the Fund to help the Asian and Latin American countries which were suffering

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from financial crisis. The interest charged by the Fund was 3% to 5% above the Fund's normal lending rates for short period.

9. ***Contingency Credit Line (CCL):*** In April 1999, CCL was created to protect fundamentally sound countries from the contagion of financial crisis occurring in other countries. Those countries were considered eligible which could finance medium-term BOP comfortably, enjoy financial sector and had strong debtor-creditor relations. No country has borrowed under this facility.

Did u know? Compensatory credit Contingency Financing Facility (CCFF) was established in August 1988.

9.3.4 Strategy Regarding Exchange Rates Policy

Members are under obligation to collaborate with the Fund and with others members, as expressed in Article I of the Articles of Agreements, to assure orderly exchange arrangements and to promote a stable system of exchange rates. The exchange rate policies are to be followed, as per the New Article IV of the second amendment of the Articles, with commitment to:

Endeavour to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

1. Seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions.
2. Avoid manipulating exchange rate or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.
3. These three principles were also given to oversee the compliance by each member of these obligations and to assure the effective operation of the international monetary system. As per the Second Amendment, these specific principles are necessary to be adopted for the guidance of members regarding exchange rate policies. These are enunciated as below:

A member shall avoid manipulating exchange rates or the international monetary system in order to prevent: effective balance of payments adjustments or to gain an unfair competitive advantage over other members.

1. A member should intervene in the exchange market, if necessary, to counter disorderly conditions which may be characterized *inter alia* by disruptive short-term movements in the exchange value of its currency.
2. Members should take into account in their intervention policies, the interests of other member, including those of the countries in whose currencies they intervene.
3. The original Fund Agreement provided that the par value of each member country was to be expressed in terms of gold of certain weight and fineness or US dollars. The idea behind it was to create a system of stable exchange rate with orderly cross rates. Later on, the Fund agreed to change in the exchange rates which did not exceed ± 1 per cent of the initial par value. A further change of ± 1 per cent is allowed but with the permission of the Fund. These provisions were changed from fixed exchange rates to flexible exchange rates in 1971. Now, the Fund has no control over the exchange rate adjustment policies of member countries. The member countries are not required to maintain and establish par values with gold or dollar.

Any country can now change the par value of its currency by 10 percent, after notifying to the Fund. If a country wants to make 20 per cent change in its par value, it must seek prior approval of the Fund. In such a case, the Fund has to communicate its decision within 72 hours. In case of

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larger change than 20 per cent, the Fund requires more time to take its decision. Such a decision is taken by 2/3rd of the members. The Fund can also change, by a majority decision, par values of all countries by a given proportion. If a member-country does not like this change, it must notify the Fund within 72 hours. A country can change its par value only if it is faced with the problem of correcting "Fundamental disequilibrium" in its balance of payments position.

9.3.5 Other Facilities

The balance of payments, exchange rate problems and monetary and fiscal issues are the other issues on which the IMF advises its member countries. The Fund has set up three departments to solve banking and fiscal problems of member countries. These departments are:

1. ***Central Banking Service Department:*** This department helps member countries with the services of its experts to manage and run their central banks. These services are especially provided to developing countries for making reforms in their banking system.
2. ***Fiscal Affairs Department:*** This department is established to provide advice on fiscal matters of the member countries.
3. ***IMF Institute:*** It conducts short-term training courses on the fiscal, monetary, banking and BOP policies for the officers of the member countries.

In addition to these, the Fund's research department publishes many reports in a year containing material relating to different policy measures. The major publications are IMF Annual Report and IMF staff papers, Finance and Development Journal, etc.

Notes Although IMF is opposed to any sort of controls either on foreign exchange or foreign trade, yet member-countries have been given the right to resort to these controls during emergency in the hope that they will lift it as early as the situation warranted.

9.3.6 Main Functions of the Fund

From the brief account of the Fund given above, it can be seen that the Fund performs several major functions. Fund deals only with the central bank or the government of a country. It has no right to interfere with the economies of the member-countries. Main functions of the Fund are enumerated below. However, some of these functions are being modified:

1. ***Determination of the rate of exchange by every country:*** When a country becomes member of the Fund, it has to declare par value of its currency in terms of dollar or gold. This facilitates multilateral convertibility of that currency.
2. ***Loan of foreign currency:*** If a country has an adverse balance of payments, the Fund gives foreign currency, required by the said country, on loan at a fixed rate of exchange. It enables the country to discharge its foreign liability. Such loans are of short duration.
3. ***Restriction on foreign currency:*** The Fund buys and sells the currencies of the member-countries. Whenever a country buys the currency of another country from the Fund, the latter makes it available by purchasing the same from the country concerned, of which it constitutes the national currency. However, in any one year, a member-country can purchase from the Fund foreign currency up to the maximum of 15% of its quota.
4. ***Bank of central banks:*** The Fund is called the Bank of the central banks of different countries of the world. Just as a central bank holds the cash reserves of the commercial banks of the country, likewise IMF also mobilizes resources of the central banks of the member-countries.

Notes

5. ***Technical assistance:*** The Fund also provides technical assistance to its member-countries. The Fund sends its experts on deputation to member-countries to advise them on matters like exchange control, foreign payments, credit money, central banking and economic policy, etc. The Fund also publishes many technical journals and magazines.

6. ***Training:*** It also imparts short-term training courses to the representatives of member-countries. This training is imparted to the senior officers of the central banks and Finance Departments. In 1975, a training centre was set up.

7. ***Facilities during emergency:*** Although IMF is opposed to any sort of controls either on foreign exchange or foreign trade, yet member-countries have been given the right to resort to these controls during emergency in the hope that they will lift it as early as the situation warranted.

8. ***It serves as a short-term credit institution:*** The Fund removes temporary difficulty of adverse BOP of any member country. It is a second line of defense. It means that the member country will maintain its separate foreign exchange reserves and the payments will be met out of these first and the balance will be given by Fund.

9. ***The fund provides a mechanism for improving short-term BOP position:*** For this purpose, its rules provide for orderly adjustment of exchange. A country can alter its rate of exchange when it feels that its rate of exchange is out of line with its economy. But this alteration can be made after the due deliberations with the authorities of the Fund.

10. ***The fund provides machinery for international consultations:*** The Fund has provided the excellent opportunity to the principal countries to sit together and reconcile their conflicting claims.

11. ***The fund promotes exchange stability*** by promoting orderly adjustments of exchange rates.

Thus, the Fund performs financial, supervisory and controlling functions.

Self Assessment

Fill in the blanks:

6. The fund provides a mechanism for improving ..... position.
7. The ..... , exchange rate problems and monetary and fiscal issues are the other issues on which the IMF advises its member countries.
8. In April, 1993, STF was established with $6 billion to help ..... and other Central Asian Republics to face balance of payments crisis.
9. Fund performs financial, ... and controlling functions.
10. The credit under ..... is provided to meet the balance of payments deficits.

9.4 World Bank

The International Bank for Reconstruction and Development (IBRD) popularly known as the World Bank, owes its birth to the deliberations of the United Nations Monetary and Financial Conference which met at Bretton Woods; New Hampshire. The World Bank was established on 1st July 1944. The Headquarters of World Bank is in Washington D. C.

The global war had completely dislocated the multilateral trade and had caused a massive destruction of life and property. While there existed a need for promptly reconstructing the war damaged economies, it was also recognized that stable world peace was threatened from the

Notes

presence of great disparities in the standards of living between the developed and underdeveloped countries. Thus, the World Bank was established.

9.4.1 Objectives of the World Bank

The main objectives of the World Bank are:

1. ***Reconstruction and Development:*** The main objective of the bank is to reconstruct the war-devastated economies like Britain, France, Holland, and to provide economic assistance to underdeveloped countries like India, Pakistan, Sri Lanka, Burma, among others.

2. ***Encouragement to Capital Investment:*** Another important objective of the Bank is to encourage private investors to invest capital in underdeveloped countries, by means of guarantees of participation in loans and other investment made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing on suitable conditions finance for productive purposes out of its own capital, from funds raised by it and its other resources.

3. ***Encouragement to International Trade:*** The third objective of the Bank is to encourage international trade. It aims at promoting long-range growth of international trade and maintenance of equilibrium in member's international balance of payments, so that the standard of living of the people of member-countries rose.

4. ***Establishment of Peace Time Economy*:** The fourth objective of the Bank is to help the member-countries change over from war-time economy to peace-time economy.

5. ***Environmental Protection:*** Global environmental protection is also an objective of the Bank. To this end, World Bank gives substantial financial assistance to those underdeveloped countries, which are engaged in the task of environmental protection.

Did u know? The World Bank was setup on 1 July 1944. The Headquarters of World Bank is in Washington D. C.

9.4.2 Membership of the World Bank and its Capital Structure

Any country that is member of IMF is *Ipso Facto* member of the Bank. Those countries who accepted the membership of the Fund on 31st December 1945 are also treated as founder members of the World Bank. Countries becoming member of the Bank subsequently had to secure *2/3rd* votes of the then existing members of the Bank. At present, 187 countries are members of the Bank. A member can withdraw its membership at any time by giving a written notice. If a country fails to observe the rules of the Bank, its membership can be terminated.

At the time of establishment, the authorized capital of the Bank was US $1,000 crore divided into 1,00,000 shares of US $1,00,000 each. Every member country had to pay 20 per cent of his quota at the time of membership. Of it, 2 per cent is in gold and remaining 18 per cent in its own currency. The balance 80 per cent of the capital subscription can be called by the Bank as and when required. The capital of the World Bank has been increased from time to time with the concurrence of the member countries. In the share of the capital of the Bank, America has the first, Japan the second and India the eighth place. In the year, 2000, the capital of the Bank has been further increased to US $18,860 crore. The authorized capital of the Bank is US $19,081 crore.

The member countries contribute their share capital to the bank as follows:

1. 2% of the share in the form of gold and US dollars. The World Bank utilizes this amount freely for granting loans.

Notes

2. 18% of the share capital in the form of own currency. The amount is also used by Bank for granting loans.
3. 80% of the share capital is payable at the request of the Bank. This amount is not used by Bank for granting loans. But it can use this amount in discharging its responsibilities.

Task Status of world bank is higher than any other commercial banking authority. Discuss in brief.

9.4.3 Management of the World Bank

Management of the World Bank vests in the following four committees:

1. ***Board of Governors:*** The Board of Governors represents the General Council of the Bank. Every member country appoints one governor and one alternative governor for five years. No alternative governor can vote except in the absence of his principal. The Board of Governors selects from its members one president who presides over its annual meeting. The Board meets normally once a year. This general meeting is convened along with the general meeting of the IMF in any member country. Each governor has the voting power as per the financial contribution of the government which he represents. The Board decides the policy of the Bank. The Board enjoys the following rights:
   (a) Admission of new members,
   (b) Termination of the membership,
   (c) Change in the capital,
   (d) Distribution of the income of the Bank,
   (e) Agreement with international institutions; and
   (f) Liquidation of the Bank.
2. ***Board of Executive Directors:*** The Board of Executive Directors consists of 22 members; of these, 5 members have the largest subscription. They are: America, Britain, Germany, France and Japan. The remaining is elected from among the other members of the Bank, for a two-year term. Board of Executive Directors can appoint any person, who is not a member, either of Board of Governors or Board of Executive Directors, as its President. The president is the chief officer of the Bank. He acts according to the directions of the Board of Directors and is responsible to it. He appoints all other officers of the Bank. Board of Executive Directors is responsible for day-to-day conduct of the Bank's operations.
3. ***Advisory Council:*** It consists of minimum 7 members. Their appointment is made by Board of Executive Directors. Members of this Council are expert on different subjects like banking, foreign trade, industry, labour, agriculture, etc. It meets once a year. The council tenders its advice on different issues to the Bank.
4. ***Loan Committees:*** Whenever the member countries apply for loans, the Board of Executive Directors appoints a Loan Committee. This Committee scrutinizes loan applications and gives its report on the propriety of the loan.

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9.4.4 Activities of the Bank

The fundamental aims underlying the World Bank's activities are:

1. The Bank is not intended to provide the external financing required for all meritorious projects of reconstruction and development; but to provide a catalyst by which production may be generally stimulated and private investment encouraged;
2. The Bank should encourage necessary action by the member governments to ensure that the Bank's loans actually prove productive. The promotion of sound financial programmes, the removal of unnecessary barrier, and the regional integration of production loans, where appropriate, are some of the fields in which the Bank may be able to exert a helpful influence; and
3. Bank must play an active rather than a passive role (and take advantage of its international cooperative character) to initiate and develop plans to the end that the Bank's resources are used not only prudently from the standpoint of its investors but wisely from the standpoint of the world.

The World Bank is primarily concerned to ensure that its loans make the greatest possible contribution to increase the production, raising the living standards of people in the borrowing member country and creating opportunities for further investment in the borrowing member country.

9.5 India and the World Bank

India has been a founder member of World Bank along with that of International Monetary Fund.

India is one of those 17 countries that prepared the agenda of Bretton Woods Conference (1944). India was one of those 44 countries who first of all signed the final draft for the establishment of the Bank. In fact, it is said that the present name of the Bank, viz., *"International Bank for Reconstruction and Development"* was suggested by India. The benefits that India has derived out of the membership of the World Bank are as follows:

1. ***Executive Director:*** India has been a permanent member of the Board of Executive Directors for many years.
2. ***Loans:*** India has received enough loans from the World Bank for its development projects. In 1949, India secured the first loan amounting to 340 lakh dollars for Indian railways. Till 1994, India had obtained loans aggregating $4,200 crore. India is the largest borrower of the World Bank; of the total loans advanced by the Bank, share of India amounts to 15 per cent. India has secured loans specially for the development of the following projects: (i) Railways; (ii) Power projects of Damodar Valley Corporation; (iii) Import of agricultural machinery; (iv) Purchase of aircrafts by Air India; (v) Development of ports; (vi) Thermal power project of Maharashtra; (vii) Coal industry (viii) Tata Iron and Steel Co.; (ix) Financial assistance to Industrial Development Bank of India and (x) Industrial Credit and Investment Corporation of India; (xi) Telecommunications; (xii) Water Supply and Sanitation; (xiii) Road Construction; (xiv) Ports and Shipping; (xv) Offshore petrol project and refineries; (xvi) Irrigation projects; (xvii) Cement, Rubber and Electronic Industry, etc. In 2000, India got the following loans from the World Bank.

Notes

Table 9.1: IBRD's Assistance to India – Sector-wise

Sector	1993	2000
1. Agriculture and Rural Development	-	1,895
2. Financial Sector	2,000	780
3. Power	3,500	6,730
4. Mining	-	3,058
5. Social Sector	-	2,753
Total	$5,500	$15,208
Of the total loans given by WB percentage share of India	5.4%	5.2%

Source: World Bank, (www.worldbank.org)

The lending position of various sectors (in million US dollars) approved in the FY 2005-06 are shown:

Table 9.2: World Bank's Assistance in Various Sectors (*in mn. dollars*)

Sector	2005-06
1. Education	36.00
2. Public Administration & Law	459.10
3. Health & Social Service	607.03
4. Transportation	250
5. Agriculture	633.45
6. Water Sanitation and Field Protection	298.25
7. Industry and Trade	36.00

Source: World Bank, (www.worldbank.org)

It is evident from the above detail that India has been borrowing too much from the World Bank.

3. ***Aid India Club or Consortium:*** In August 1950, Aid India Club was founded by the efforts of the World Bank with a view to providing financial assistance and foreign currency to India. Among its members are countries like America, England, Japan, Germany, and Canada. The club has given substantial amount of loans in the form of foreign currency to India. On 21st June, 1993, India got loans and assistance worth $670 crore from this club. It is now called India Development Forum. In its first meeting held on 29th July, 1994, 15 private corporations of India and many multinational corporations were invited. It was decided in this meeting that India be given loans amounting to $ 600 crore for implementing its structural adjustment.

4. ***Mediation between Indo-Pak River Water Dispute:*** On the matter of sharing of water of the rivers of Punjab, a serious dispute took place between India and Pakistan. To find a solution to the problem, World Bank acted as a mediator. As a result, both the countries were brought to the negotiating table in 1952 and in 1959 the dispute was amicably settled.

5. ***Facilities for General Loans:*** India has obtained from the World Bank, facilities for general loans. It implies such loans as can be utilized by India as per its own discretion.

6. ***Advantages from membership of sister institutions of the World Bank:*** As a member of the World Bank, India has availed of the membership of its sister institutions.

Notes

(a) *International Finance Corporation:* This corporation was set up in 1960 to provide loans to the private sector of the member countries. By far, 57 companies of India have been able to secure foreign investment worth $121 crore through this corporation.

(b) *International Development Association:* It was founded in 1960 with the objective of providing loans to poor countries on concessional rate. India obtained a loan of 90.3 crore dollars from this Association in 1997. These loans are mainly meant for agriculture, population control and development of roads.

(c) *Multinational Investment Guarantee Agency:* It was established in 1988. Its objective is to give guarantee against risk, so as to encourage foreign investment in the private sector of developing countries. India became its member in 1993.

7. ***Technical Assistance:*** World Bank has provided from time-to-time, technical assistance to India for its varied projects. It has sent about 15 Expert teams to India. After surveying different parts of the country and assessing the development projects in India, these experts gave several valuable suggestions for their development. World Bank has its Resident Representative at New Delhi. He has a constant liaison with the Government of India regarding development projects.

8. ***Population Control Assistance:*** World Bank has given loans amounting to $495 crore to India for effective implementation of population control programme and for urban development.

9. ***Help to Non-governmental Organization:*** World Bank has given financial assistance to many non-governmental organizations involved in public welfare activities. Some of the main projects are

   (a) National Leprosy Elimination

   (b) Basic Education Project

   (c) Child Development Services Project, etc.

The World Bank has been largely instrumental in accelerating the pace of economic development in different countries of the world. The purpose of the Bank can be fulfilled only when the rate of interest charged by the bank is low enough for all countries to enable them to take loans from the bank more frequently. The Bank is a non-political institution expected to treat all member equally and not to discriminate among them.

It is hoped that in future the World Bank will be in a stronger positions to render financial assistance to the member countries with its increased capital, resources and the active co-operation of its affiliates, i.e., the International Development Association (IDA) and the International Finance Corporation (IFC).

Self Assessment

Fill in the blanks:

11. The ..... has been largely instrumental in accelerating the pace of economic development in different countries of the world.

12. The purpose of the Bank can be ..... only when the rate of interest charged by the bank is low enough for all countries to enable them to take loans from the bank more frequently.

13. The Bank is a ..... expected to treat all member equally and not to discriminate among them.

Notes

14. In August 1950, ... was founded by the efforts of the World Bank with a view to providing financial assistance and foreign currency to India.

15. ..... has been a founder member of World Bank along with that of International Monetary Fund.

Case Study

What the IMF has Done?

ICELAND called in the IMF two years ago following an unprecedented meltdown in the country's banking system. Today, the island nation remains mired in problems, with the IMF estimating that 63pc of loans to households and businesses are non-performing. Last month, about 8,000 Icelanders took to the streets to voice their grievances. The economy, the world's fifth-richest per capita as recently as 2007, contracted 6.8pc last year and shrank an annual 8.4pc in the second quarter of 2010. The country's prime minister Johanna Sigurdardottir is trying to protect the 39pc of households that are technically insolvent. The IMF does not want her to force lenders to forgive $2bn (€1.46bn) in mortgage debt but she is still looking at some form of debt-forgiveness. Her government is also pushing a bill that will allow bankrupts to walk away from their debts after two years. It also presented a foreign-lending bill that will reduce each household's debt burden by $13,500 (€9,870), leaving lenders liable. She extended by five months a moratorium on foreclosures, breaching the IMF agreement.

HUNGARY

Population: 10m

Currency: Forint

10-year yield: 7.01pc

Unemployment rate: 11.4pc

S&P rating: BBB-

HUNGARY received a bailout in 2008 to prevent default.

Recently, the country has ended special corporate taxes in an effort to bring down the deficit through 2012 and introduced a flat personal-income tax rate. The country's prime minister, Viktor Orban, has also imposed a three-year tax regime on the financial, energy, telecommunications and retail industries. The European Union country will cut as many as 30,000 public sector jobs next year to help cut the fiscal gap to 2.94pc of GDP from 3.8pc this year, and will use revenue from private pension savings to reduce the country's debt. The government has taken a red pen to pensions and has stopped paying into private funds until the end of next year at least. It also pledged in September to narrow the gap to 3.8pc of GDP this year and below 3pc in 2011, abandoning a fight with the IMF and EU over the same targets. Hungary plans to use new taxes to finance a reduction in the personal-income tax rate to 16pc, a move designed to help boost growth.

LATVIA

Population: 2.27m

Currency: The Lat

10-year yield: 5.12pc

Unemployment: 15pc

S&P rating: BB+

Contd...

Notes

LATVIA turned to a group led by the IMF and the European Union for a €7.5bn loan in 2008 after its second-biggest bank failed. Latvia's programme would be like an Irish programme; the country is keeping its exchange rate fixed to the euro, while letting wages and prices fall to restore competitiveness. The economy expanded 2.7pc in the third quarter for the first time since the Baltic state followed the European Union's toughest austerity measures. The economy is recovering after shrinking about 25pc through nine quarters of decline. Yarkin Cebeci, an economist at JP Morgan Chase, estimates that growth next year may reach 3pc as industrial production expands 20pc. Standard & Poor's and Fitch Ratings, which cut Latvia's credit rating to junk in 2009, raised their outlooks to stable this year. Moody's Investors Service, which rates Latvia Baa3, its lowest grade, also raised its outlook to stable. Latvia is still making cuts as it battles to bring its budget deficit down to 6pc of GDP next year. Lawmakers already approved austerity measures equal to about 14pc of economic output since the IMF and EU bailout.

GREECE

Population: 11.2m

Currency: Euro

10-year yield: 11.2pc

Unemployment: 12.2pc

S&P: BB+

THE only Eurozone country that has had to call on the IMF for help, Greece activated a €110bn package of loans from the EU and IMF in May to bail out the country. Ireland would probably use the same mechanism if leaders here turned overseas for help. Prime Minister George Papandreou has since cut wages and pensions and raised taxes on fuel, tobacco and alcohol, but the measures have sparked massive protests. He came to power a year earlier with promises to raise salaries and cut taxes. The Greeks may have been unhappy but the markets liked the cutbacks and the spread on Greek 10-year bonds, and German bonds of the same maturity narrowed to 649 basis in early October -- close to Irish levels -- but jumped again after Mr Papandreou suggested he might call elections just 18 months after the previous elections because his political support was dwindling.

Other cutbacks planned include the merger of 1,034 local municipalities into 325, and the replacement of 67 regional and prefectures with 13 more powerful regional authorities.

Questions

1. Discuss the case in elaborative way.
2. What was the problem behind the case study

Source: http://www.independent.ie/national-news/case-studies-what-the-imf-has-done-2420251.html

9.6 Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- To review, we have looked at the relationship between institutions and long run economic growth.
- This growing field of research may offer us a new insight into the dynamics of economic growth within and among various economies.

Notes

9.7 Keywords

Budget: An amount of money set aside to cover the total cost of a communication campaign or other marketing activity.

Foreign Exchange: Facilities' business across national boundaries, usually expressed in foreign currency bought or sold on the foreign exchange market.

GAB: General Arrangements to Borrow

Joint Ventures: An enterprise in which two or more investors share ownership and control over property rights and operations.

NAB: New Arrangements to Borrow

SAF: Structural Adjustment Facility

9.8 Review Questions

1. Explain the role of financial institutions.
2. How is the World Bank managed?
3. What are the objectives of IMF?
4. Enumerate the various strategies of the IMF.
5. Mention the activities of the World Bank.
6. Write short note on World Bank membership and its capital structure.
7. What are the objectives of World Bank?
8. Write a short note on the background of IMF.
9. Name the functions of IMF.
10. Evaluate the relationship of India with World Bank.

Answers: Self Assessment

1.	IMF	2.	187
3.	National currencies	4.	Tranche policies
5.	Five	6.	Short-term BOP
7.	Balance of payments	8.	Russia
9.	Supervisory	10.	EFF
11.	World Bank	12.	Fulfilled
13.	Non-political institution	14.	Aid India Club
15.	India		

Notes

9.9 Further Readings

Books

C.B. Gupta, *Business Environment.*

Francis Cherunillam, *Global Business Environment.*

M. Kapagam, *Environmental Economics*.

Philip R. Cateora, *International Marketing*.

Online links

http://www.ciepac.org/docs/desbanquemos-ing.pdf

http://www.willembuiter.com/builan.pdf

www.globalization101.org/uploads/File/IMF/imfall2011.pdf

http://www.foreign.senate.gov/imo/media/doc/55285.pdf

Unit 10: International Financial Institutions-II

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Objectives

After studying this unit, you should be able to:

- Understand the scope of International Finance Corporation
- Study the IDA and its role
- Discuss the International Liquidity concept
- Elaborate the concept of Special Drawing Rights (SDR)

10.1 International Development Association (IDA)

The IDA was formed in 1960 as a part of the World Bank Group to provide financial support to LDCs on a more liberal basis than could be offered by the IBRD. The IDA has 137 member countries, although all members of the IBRD are free to join the IDA. IDA's funds come from subscriptions from its developed members and from the earnings of the IBRD. Credit terms usually are extended to 40 to 50 years with no interest. Repayment begins after a ten-year grace period and can be paid in the local currency, as long as it is convertible. Loans are made only to the poorest countries in the world, those with an annual per capita gross national product of $480 or less. More than 40 countries are eligible for IDA financing.

An example of an IDA project is a $8.3 million loan to Tanzania approved in 1989 to implement the first stage in the longer-term process of rehabilitating the country's agricultural research system. Co-financing is expected from several countries as well as other multilateral lending institutions.

Notes

Although the IDA's resources are separate from the IBRD, it has no separate staff. Loans are made for similar projects as those carried out by IBRD, but at easier and more favourable credit terms.

As mentioned earlier, World Bank/IDA assistance, historically, has been for developing infrastructure. The present emphasis seems to be on helping the masses of poor people in the developing countries become more productive and take an active part in the development process. Greater emphasis is being placed on improving urban living conditions and increasing productivity of small industries.

Did u know? The IDA was formed in 1960 as a part of the World Bank Group.

10.2 International Liquidity

The concept of international liquidity is associated with international payments. These payments arise out of international trade in goods and services and also in connection with capital movements between one country and another. International liquidity refers to the generally accepted official means of settling imbalances in international payments.

In other words, the term 'international liquidity' embraces all those assets which are internationally acceptable without loss of value in discharge of debts (on external accounts).

In its simplest form, international liquidity comprises of all reserves that are available to the monetary authorities of different countries for meeting their international disbursement. In short, the term 'international liquidity' connotes the world supply of reserves of gold and currencies which are freely usable internationally, such as dollars and sterling, plus facilities for borrowing these. Thus, international liquidity comprises two elements, viz., owned reserves and borrowing facilities.

Under the present international monetary order, among the member countries of the IMF, the chief components of international liquidity structure are taken to be:

1. Gold reserves with the national monetary authorities - central banks and with the IMF.
2. Dollar reserves of countries other than the U.S.A.
3. £-Sterling reserves of countries other than U.K.

   It should be noted that items (2) and (3) are regarded as 'key currencies' of the world and their reserves held by member countries constitute the respective liabilities of the U.S. and U.K. More recently Swiss francs and German marks also have been regarded as 'key currencies'.
4. IMF tranche position which represents the 'drawing potential' of the IMF members; and
5. Credit arrangements (bilateral and multilateral credit) between countries such as 'swap agreements' and the 'Ten' of the Paris Club.

Of all these components, however gold and key currencies like dollar today entail greater significance in determining the international liquidity of the world.

However, it is difficult to measure international liquidity and assess its adequacy. This depends on gold and the foreign exchange holdings of a country, and also on the country's ability to borrow from other countries and from international organisations. Thus, it is not easy to determine the adequacy of international liquidity whose composition is heterogeneous.

Notes

Notes The IDA has 137 member countries, although all members of the IBRD are free to join the IDA.

Moreover, there is no exact relationship between the volume of international transactions and the amount of necessary reserves. In fact, foreign exchange reserves (international liquidity) are necessary to finance imbalances between international receipts and payments. International liquidity is needed to service the regular. How of payments among countries, to finance the shortfall when any particular country's out payments temporarily exceed its in-payments, and to meet large withdrawals caused by outflows of capital.

Thus, external or internal liquidity serves the same purpose as domestic liquidity, viz., to provide a medium of exchange and a store of value. And the primary function of external liquidity is to meet short-term fluctuations in the balance of payments.

Self Assessment

Fill in the blanks:

1. ..... tranche position which represents the 'drawing potential' of the IMF members.
2. 'International liquidity' embraces all those assets which are ..... acceptable without loss of value in discharge of debts (on external accounts).
3. It is difficult to measure international ..... and assess its adequacy.
4. International liquidity comprises two elements, viz., ... and borrowing facilities.
5. Although the IDA's resources are separate from the ....., it has no separate staff. Loans are made for similar projects as those carried out by IBRD, but at easier and more favourable credit terms.

Caution Inequality in international receipts and payments are concerned through foreign exchange reserves. But, reserves cannot identify the volume of international transactions.

10.3 Special Drawing Rights (SDRs)

With effect from January 1, 1970, for increasing international liquidity IMF created a system of Special Drawing Rights (SDRs). The SDRs are designed to supplement gold and the reserve currencies, viz., the pound and the dollar. The SDRs represent entirely a new form of paper money which will serve as well as gold or dollar, and hence are called "Paper Gold".

According to the system adopted w.e.f. January 1, 1989. The value of SDR is determined on the basis of the basket of 5 most widely used currencies of member countries. These include U.S. Dollar, British Pound, French Franc, German's Mark and Japanese Yen. Till date, it is defined in terms of basket of these give currencies. As of now, the determination of value of SDR is based according to the weightage of the currencies as given in Table 10.1.

Notes

Table 10.1: Determination of Value of SDR

1. American Dollar	41.9%
2. Euro	37.4%
3. Japanese Yen	9.4%
4. British Pound	11.3%
Total	**100%**

Did u know? Starting January 1, 1970, IMF created a system of "Special Drawing Rights" to increase international liquidity.

10.3.1 Features of SDRs

Main features of SDRs are as under:

1. It has no backing of any fund. There is book entry only.
2. IMF has opened a separate special account.
3. It is a method of augmenting existing liquid funds and has resulted in increasing international liquidity.
4. The number of shares a member-country holds in IMF are in the same proportion it has its share in SDR.
5. SDR is used to meet unfavourable balance of payments and also to make up unexpected shortage of liquid funds. When an exporting country advances its currency to importing country, SDRs of the said amount are credited into the account to exporting country and debited to the account of importing country.
6. Since January 1981, SDR is evaluated on the basis of basket of currencies of five nations. These five nations are the largest exporters of the world. Since January 1, 1998, some changes have been effected in the weightage and value of one unit of SDR (as shown in table 10.1), because there is a provision to effect change in weightage and value of SDR every five years. Whenever, there is change in the value of these currencies, there is corresponding change in the value of one unit of SDR.
7. The country which makes use of SDR, the volume of its reserve goes down and the country that provides foreign exchange in lieu of SDR records a rise in value of its accumulated SDRs. There is also a provision of paying simple interest, at the rate of 1.5 per cent, on the quantum of SDRs of these countries.

Notes The SDRs are designed to supplement gold and the reserve currencies, viz., the pound and the dollar.

10.3.2 Allocation of SDRs

The fund allocates SDRs to participants in proportion to their quotas for various uses mentioned above. From 1970–72, initially SDR $9.3 billion were created by the Fund. This holding continued till 1978. SDR $4 billion were raised in each of the years 1979, 1980 and 1981. As a result, the total holding of SDRs was $21.4 billion in 1981. Since 1981 no further allocation of SDRs has been

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made by the fund. At present, about 70% of SDRs are distributed among 26 rich countries and the remaining 30% among developing countries. Consequent upon increase in the shares of member-countries of IMF in April 1998, the total holding of SDR has gone up to 214 billion SDRs or 293 billion American dollars.

10.3.3 SDRs and India

India was allocated SDRs in the name of Government of India since January 1970. These SDRs do not enter into the accounts of the RBI. During 1979–81, India was given further allocations on the basis of its quota with the Fund beginning with January 1979. India's total allocation was of SDR 4,156.20 million as on March 31, 2007. The current details are shown in the chart 11.1.

Chart 10.1: India's Financial Position in the Fund as on 31 May, 2011

I. Membership Status: Joined: December 27, 1945; Article VIII

II. General Resources Account:	**SDR Million**	**%Quota**
Quota	5,821.50	100.00
Fund holdings of currency (Exchange Rate)	4,289.57	73.68
Reserve Tranche Position	1,532.18	26.32
Lending to the Fund		
New Arrangements to Borrow	750.00	

III. SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	3,978.26	100.00
Holdings	2,882.68	72.46

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Oct 31, 1991	Jun 30, 1993	1,656.00	1,656.00
Stand-By	Jan 18, 1991	Apr 17, 1991	551.93	551.93
EFF	Nov 09, 1981	May 01, 1984	5,000.00	3,900.00

Source: www.imf.org

Did u know? At the end of January 1987, India's SDR holdings were ₹ 198 million.

10.3.4 Evaluation of the Functioning of IMF

IMF has been functioning for a long-time. During this period it has achieved its objectives to a large extent and at the same time its programmes have also been subjected to criticism.

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Caselet

McDonald's in India: Reaching Out Customers with McDelivery

In 2010, McDonald's came out with the idea of web-based delivery model, to enhance its concept of McDelivery (introduced in 2004). The web-based delivery model, wherein the customer places order through the company's website, was piloted in four McDonald's outlets across Hyderabad. If successful, the company plans to take it pan-India. The case study analyses McDonald's India's operations and the existing distribution system of the company. It also looks into the web-based delivery model and the challenges of the same. It provides scope to analyse whether in a fast food industry – where quick service and convenience for customers are priorities – the web-based distribution model can satisfy the customers as well as the fast food chains (in terms of sales and revenues).

Source: http://www.ibscdc.org/Case_Studies/Marketing/Sales%20and%20Distribution/SDN0013.htm

10.3.5 Achievements

According to Halm, "*Fund is like an International Reserve Bank.*" The Fund has performed the following significant functions to attain its objectives:

1. ***International Monetary Cooperation:*** One of the main objectives of the Fund was to present a forum where most of the countries of the world may be able to solve their monetary problems by mutual cooperation. IMF has succeeded in achieving this objective.
2. ***Reconstruction of European Countries:*** Because of the efforts of the Fund, rich countries like America gave liberal economic assistance under Marshall Plan for the reconstruction of European countries. But for this Plan, war-devastated European countries could not have been rehabilitated.
3. ***Multilateral Systems of Foreign Payments:*** At the time of the establishment of the Fund, almost all countries were practicing exchange control in one way or the other. There were many restrictions on foreign trade. IMF has succeeded in reducing the same and in establishing multilateral system of foreign payments.
4. ***Increase in International Liquidity:*** Corresponding to increase in international trade, the Fund has succeeded in increasing international liquidity. On the one hand, the Fund has increased its resources from 2920 cr. SDRs to 21,200 cr. SDRs; on the other, it has created a new liquid asset in the form of SDR. As a result, international liquidity has increased manifold.
5. ***Increase in International Trade:*** The Fund has succeeded in expanding the international trade and making it free from restrictions to a large extent. It has rendered payments relating to international trade easy. By helping the countries suffering from trade disequilibrium, it has promoted their trade. All this has resulted into expanding the value of world's exports from 53 billion dollars in 1948 to more than 2000 billion dollars at present.
6. ***Special Aid to Developing Countries:*** The Fund has done a special service to developing countries in finding a solution to their problems. It has been actively helping them in correcting their unfavourable balance of payments and achieving monetary stability. These countries have been receiving adequate assistance from the Fund in determining their monetary, export- import and exchange policies. It has provided technical assistance to them besides imparting training to their senior officers.

7. ***Helpful in Times of Difficulties:*** The Fund has come to the rescue of all member countries faced with economic crisis. On account of hike in petrol prices, many countries of the world experienced acute shortage of foreign exchange. In order to ease this situation, it set up Petrol Facility Fund.

Task Describe trade disequilibrium.

10.3.6 Failures of International Monetary Fund

Despite the achievements made, the Fund has also failed to achieve some of its objectives. Its chief failures are as under:

1. ***Lack of Exchange Stability:*** The Fund has failed to achieve its main objective of exchange stability. It succeeded till 1971 in maintaining Fixed Rate of Exchange. Thereafter, it became variable once again. Lack of stability in exchange rate is the major failure of the Fund.
2. ***Lack of Stability in the Price of Gold:*** Strenuous efforts were made by the Fund to bring stability in the price of gold but it failed miserably. Up to 1971, the price of gold was kept stable at $35 per oz; but thereafter it could not remain stable and rose to $1500 per oz.
3. ***Inability to Remove Exchange Control:*** The Fund has failed to remove restrictions on foreign trade and control on foreign exchange. Many countries of the world have resorted to policy of protection with greater vigour.
4. ***Rich Countries' Club:*** Critics say that International Monetary Fund is a club of rich countries. It works at the behest of rich countries like America, Britain, etc., and helps their supporters. It pursues a policy of discrimination.
5. ***Charitable Institution:*** Other critics point out that it is a charitable institution whose main function is to provide the resources of some rich countries to their supporter countries to enable them to correct disequilibrium in their balance of payments. Such a help instead of promoting their economic development renders them more careless and increases their foreign indebtedness.
6. ***No Solution for International Liquidity:*** IMF does not have a proper solution for international liquidity. Although Fund has considerably increased its permanent resources and helped in the creation of a new currency in the form of Special Drawing Right (SDRs), yet the problem of liquidity persists. Consequently, it will be difficult for the Fund to lend resources to developing countries and help them tide over their balance of payments deficit.
7. ***No Elimination of Multiple Exchange Rates:*** Another aim of the Fund was to eliminate multiple exchange rates but it has not succeeded therein. Multiple exchange system refers to a system wherein a country adopts different exchange rates for different transactions. For instance in 1971, France had adopted two exchange rates, fixed exchange rate for genuine trade transactions and flexible rate of exchange for speculative transactions.
8. ***Inability to Tackle the Monetary Crisis of August 1971:*** In the year 1971, a global monetary crisis triggered off when America not only devalued dollar but also stopped its convertibility into gold. The Fund failed to resolve this crisis. Rather, due to this crisis, the Fund had to bid good-bye to its objectives like gold standard and fixed exchange rate. It was the biggest failure of the Fund.
9. ***Discriminatory Policies:*** The major cause of criticism of the Fund is its discriminatory policies in favour of developed countries and against the developing countries. US and

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other developed countries dominated the Fund, although the majority of its members are the developing countries. Generally, a rigid attitude regarding grant of loans to developing countries is adopted by the developed countries, especially by United States.

It is evident from the above account that International Monetary Fund has largely failed to achieve its objectives. No wonder, many countries are insisting on its re-organization.

10.3.7 Future Directions

Prof. Anna Schwartz and Friedman have criticized IMF for global financial crisis and pleaded for abolishing it. Prof. Samuelson, on the other hand, praised the working and achievements of IMF in his article "Three Cheers" for the IMF published in 1997. Horst Kohler, The former Managing Director of the Fund himself admitted: *"IMF is not a God that knows everything"*. It means that there is a need to improve its policies by the Fund. The following measures for this purpose have been suggested at different economic forums:

1. ***Contagion Effect:*** The IMF should make provision for giving financial help on concessional terms to those countries which have a fear of contagion effect of the financial crisis of other countries.
2. ***Safety net:*** The Fund should formulate a plan which acts as a safety net for countries during economic crisis.
3. ***Justifiable Global Trading System:*** The Fund should also establish a free global trading system which is proper and justifiable towards developing countries.
4. ***Equitable Distribution of Voting Right:*** The voting rights should be equally distributed among participating countries. For this purpose, the quota may be refixed.
5. ***Transparency:*** The loan practices should be changed by the Fund to increase transparency. For getting back the amount quickly, the Fund should reduce the maturity period and in case of default, a penal interest rate should be charged.
6. ***Conditional Loans:*** The Fund should provide loans on such terms and conditions which make them able to increase their internal resources and do self-financing for their economic programmes in the long run.
7. ***Macro-economic Policies for Developed Countries:*** The IMF should formulate such macro-economic policies for developed countries that provide safety to the growth of world output and trade. They should act as highly effective safety net for the global economy.

Self Assessment

State whether the following statements are true or false:

6. The voting rights should be equally distributed among participating countries.
7. The IMF should not make provision for giving financial help on concessional terms to those countries which have a fear of contagion effect of the financial crisis of other countries.
8. The loan practices should be changed by the Fund to increase transparency.
9. The IMF should not formulate such macro-economic policies for developed countries that provide safety to the growth of world output and trade.

10.4 International Finance Cooperation (IFC)

The IFC was established in 1956. There are 133 countries that are members of the IFC and it is legally and financially separate from the IBRD, although IBRD provides some administrative

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and other services to the IFC. The IFC's main responsibilities are (i) To provide risk capital in the form of equity and long-term loans for productive private enterprises in association with private investors and management (ii) To encourage the development of local capital markets by carrying out standby and underwriting arrangements and (iii) To stimulate the international flow of capital by providing financial and technical assistance to privately controlled finance companies. Loans are made to private firms in the developing member countries and are usually for a period of seven to twelve years.

The key feature of the IFC is that its loans are all made to private enterprises and its investments are made in conjunction with private business. In addition to funds contributed by IFC, funds are also contributed to the same projects by local and foreign investors.

Caution Apart from the provision of some administrative and other services, IBRD and IFC hold separate legal and financial entity.

IFC investments are for the establishment of new enterprises as well as for the expansion and modernization of existing ones. They cover a wide range of projects such as steel, textile production, mining, manufacturing, machinery production, food processing, tourism and local development finance companies. Some projects are locally owned, whereas others are joint ventures between investors in developing and developed countries. In a few cases, joint ventures are formed between investors of two or more developing countries. The IFC has also been instrumental in helping to develop emerging capital markets.

In India, our engagement is a gauge of leadership from IFC and its clients. Our **vision** is to show that private enterprises can be partners with the government and NGOs to curb the epidemic. Along with other players such as UNAIDS, India's National AIDS Control Organization (NACO), the International Labor Organization (ILO), the Confederation of Indian Industry (CII), Federation of Indian Chambers of Commerce and Industry (FICCI), and the World Bank, IFC is raising awareness about the crucial role that the private sector can play in India to address HIV/AIDS, a role which is very limited at this time (the number of corporate engaged on HIV/AIDS in India is estimated to be about 70 companies according to the ILO).

IFC against AIDS is expanding its work in India by providing strategic technical assistance. After evaluating what could be done to bring value to IFC clients and contribute to the national efforts to face the epidemic, IFC Against AIDS launched a program in January 2005 aimed at raising the ability of clients to proactively address HIV/AIDS in three possible areas:

- ***Workplaces:*** By raising awareness about HIV/AIDS and promoting prevention across company operations, and by extending education programmes throughout their groups and to supply chain partners.
- ***Company Clinical Facilities:*** By training medical and clinical staff on HIV/AIDS and sexually transmitted infections (STIs), i.e. modes of transmission, prevention (with a special focus on universal precautions related to HIV infection in clinical settings), basic counselling skills, syndrome management of STIs, opportunistic infections related to HIV and anti-retroviral treatment therapies.
- ***Their Communities:*** By supporting and scaling-up the awareness and prevention efforts around their operations, particularly among migrant workers and trucking communities with whom companies interact.
- IFC against AIDS and IFC's Corporate Citizenship Facility (CCF) are providing financial support to clients of up to 50% of eligible costs for projects, up to a year and a half of engagement.

We consider our current programme as a catalyst for participation by larger corporate which are within IFC's area of influence. Our goal with this program is to have a vast geographic area

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represented, as well as a wide variety of sectors, to enhance the scope and breadth of lessons learnt.

With the help of NGO partners, IFC Against AIDS is looking into areas of possible extensions of client programs in the formal supply chain of those enterprises (small and medium enterprises). Indeed it is a lot harder for smaller companies to initiate and implement programmes (primarily because of motivation and capacity). Ultimately, IFC against AIDS's goal is to go beyond the big corporate into those companies, which form a large part of India's economic structure. In this area, we will look to leverage our work with SMEs in Africa to develop a culturally appropriate and effective programme in India as well.

Case Study

IFC's Footprint Commitment

IFC, a member of the World Bank Group, has made a public commitment—"IFC's Footprint Commitment"—to make sustainability an integral part of its day-to-day work in IFC offices around the world, and to continually improve the environmental performance of IFC's internal operations. FC headquarters office in Washington D.C., encompassing 1,138,000 gross square feet and over 2,560 workstations to accommodate staff, consultants and contractors.

The IFC Facilities Management Unit has been leading the way in making important technological and process adjustments in the way the D.C. office functions, saving an estimated 1.6 million kilowatt hours of electricity, 4.1 million gallons of water, and diverting 257 tons of waste/recyclables from the landfill in 2009 alone. In FY09, Facilities Management committed to a 10% electricity-reduction target for the D.C. office over the next five years (in addition to the 17.4% reduction achieved since FY02).

Since December 2004, IFC has bought renewable energy certificates (RECs) to cover 100% of the electricity use in its D.C. office. In addition, the Unit is leading the effort for LEED certification for the D.C. building (The building received the Energy Star Label for 1999, 2001, and for 2004 through 2008). Examples of other best-practice facilities-based changes are outlined below:

Water	Savings
Water-closet flush valve conversion	3,000,000 gallons
Lavatory faucets flow reduction	737,375 gallons
Shower-head flow reduction	151,875 gallons
Urinal flow reduction	131,250 gallons
Pantry-faucet flow reduction	86,250 gallons

Energy	Savings
Operational hours for central HVAC and lighting systems shortened	510,000 kWh
Variable Frequency Drives (VFDs) installed on large cooling-tower motors	303,030 kWh
50% of fluorescent bulbs removed on 10 floors in open office areas	453,000 kWh
Replaced incandescent lights with compact florescent light bulbs (CFLs)	293,000 kWh
Turned off drive lane lighting on parking levels B2, B3, B4	72,000 kWh

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Waste & Recycling in FY 20009	Amounts Collected
IFC small-item "Recycling Center"	160 pounds technotrash, 371 pounds batteries diverted from landfill
Cardboard recycling	24 tons of cardboard diverted from landfill
Paper, glass, plastic and aluminum recycling efforts	176 tons of paper 3.6 tons of glass, plastic, and aluminum diverted from landfill
Sold 600 desk chairs for re-use, and recycled 65,850 pounds of office furniture	Estimated 42 tons furniture diverted from landfill Pantry-faucet flow reduction
Recycled 1,031 PCs	Estimated 5 tons of electronic equipment diverted from landfill
Recycled 95,700 pounds of carpet	48 tons of carpet material diverted from landfill

Carbon Footprint

Emissions from IFC's D.C. operations represent about half of IFC's overall corporate impact. IFC has been carbon-neutral for all its D.C. operations since 2006. This has been achieved through:

- Calculating greenhouse-gas emissions from internal business operations, which includes staff air travel, electricity used by the D.C. office, fuel use for vehicles and machinery and natural gas and refrigerants used.
- Reducing carbon emissions through familiar and innovative energy-saving measures
- Purchasing carbon "offsets" for emissions that cannot be reduced

Food Service

The World Bank Group's food service provider, Restaurant Associates, was chosen partly because of their environmentally preferable products and services. This includes "greener" disposables like potato-based utensils, post-consumer paper containers, and post-consumer fiber cups; fair trade, organic coffee; transfat-free oils; rBGH-free dairy items; seafood purchases based on the Monterey Bay Aquarium Sustainable Seafood Watchlist; cagefree eggs; and organic items, where available. Surplus food is donated to D.C. Central Kitchen.

"10-Minute Tune Up"

In 2009, the Footprint Program launched the "10-Minute Tune Up," with the goal of sharing simple ways IFC staff could use resources more efficiently while at work—in a quick 10 minutes. The Tune Up is implemented in each department ("desk-by-desk") by a team of Footprint Champions, who go through a checklist of succinct, simple suggestions and help staff make easy one-time changes (such activating energy-saving features on their computers). Each "Tuned Up" staff person receives an emblem for their desk and is entered into a raffle for prizes. In this program's first year, over 800 staff (almost 30%) were "Tuned Up," including many senior-level staff.

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IFC is the first of all UN agencies to be carbon-neutral for all global business operations.

Top Row (from left to right):

- Maria Fyodorova, Sustainability/CSR Communications Consultant, IFC Footprint Program
- Chris Potkay, Chief Engineer, Brandywine Realty Trust, IFC Facilities Management Unit
- Sarah Raposa, Program Officer, IFC Footprint Program
- Nina Shapiro, Vice President, Finance and Treasurer of IFC and Chair of the IFC Footprint Program Advisory Committee
- Vanessa Ferragut, CMP, Events & Outreach Consultant, IFC Footprint Program
- Adam Rubinfield, Sustainability Coordinator, WB Corporate Responsibility Program

Bottom Row (from left to right):

- Robert Pearlman, Sr. Facilities and Administration Officer, IFC Facilities Management Unit
- Christine Jones, Property Manager, Brandywine Realty Trust, IFC Facilities Management Unit

Not Present:

- Bilal Rahill, Manager, Environment and Social Development Department, IFC
- Elizabeth B. Casqueiro, Manager, IFC Facilities Management Unit
- Judith Moore, Team Leader, WB Corporate Responsibility Program
- Monika Kumar, Sustainability Coordinator, WB Corporate Responsibility Program
- Viki Betancourt, Manager, WBG Community Outreach

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- IFC's carbon footprint accounts for greenhouse gases (GHG) from internal business operations. The total emissions—including carbon dioxide, methane, and nitrous oxide—are translated into metric tons of carbon dioxide equivalent (tCO2e), so that the total impact can be summed in one figure.

Questions

1. Elaborate the case study.
2. Focus on the issue of case study.

Source: http://ddoe.dc.gov/service/case-study-international-finance-corporation

Self Assessment

Fill in the blanks:

10. IFC against ..... is expanding its work in India by providing strategic technical assistance.
11. The IFC was established in ..... .
12. With the help of ..... partners, IFC Against AIDS is looking into areas of possible extensions of client programs in the formal supply chain of those enterprises.
13. There are ..... countries that are members of the IFC
14. The key feature of the IFC is that its loans are all made to ..... enterprises.
15. The IFC has also been instrumental in helping to develop emerging ..... markets.

10.5 Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- The concept of international liquidity is associated with international payments. These payments arise out of international trade in goods and services and also in connection with capital movements between one country and another. International liquidity refers to the generally accepted official means of settling imbalances in international payments.
- With effect from January 1, 1970, for increasing international liquidity IMF created a system of Special Drawing Rights (SDRs). The SDRs are designed to supplement gold and the reserve currencies, viz., the pound and the dollar. The SDRs represent entirely a new form of paper money which will serve as well as gold or dollar, and hence are called "Paper Gold".
- The key feature of the IFC is that its loans are all made to private enterprises and its investments are made in conjunction with private business. In addition to funds contributed by IFC, funds are also contributed to the same projects by local and foreign investors.

10.6 Keywords

IFC: International Finance Corporation

IMF: International Monetary Fund

International Liquidity: International liquidity comprises of all reserves that are available to the monetary authorities of different countries for meeting their international disbursement.

LDC: Least Developed Country

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SDR: Special Drawing Rights

STIs: Sexually Transmitted Infections

10.7 Review Questions

1. Explain the role of financial institutions.
2. Briefly explain the functioning of World Bank.
3. What is the importance of IMF?
4. Mention the chief components of international liquidity structure.
5. What are SDRs? Enumerate the chief features of SDRs.
6. How are SDRs allocated?
7. List the achievements of IMF.
8. In which fields has IMF faced failure?
9. Mention the future course of action which IMF plans to undertake.
10. Enumerate the areas in which IFC proactively addressed HIV/AIDS.

Answers: Self Assessment

1.	IMF	2.	Internationally
3.	Liquidity	4.	Owned reserves
5.	IBRD	6.	True
7.	False	8.	True
9.	False	10.	AIDS
11.	1956	12.	NGO
13.	133	14.	Private
15.	Capital		

10.8 Further Readings

Books

C.B. Gupta, *Business Environment.*

Francis Cherunillam, *Global Business Environment.*

M. Kapagam, *Environmental Economics*.

Online links

http://cogito.ucdc.ro/nr_2v2/INTERNATIONAL%20FINANCIAL%20INSTITUTIONS.pdf

http://www.paclii.org/vu/legis/consol_act/ifi376.pdf

http://www.g24.org/Dpseries/Kanbur.pdf

Unit 11: Basics of International Marketing

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Objectives

After studying this unit, you should be able to:

- Discuss the basics and functions of international marketing
- Describe the relationship with other fields of study
- Elaborate global marketing strategies

Introduction

This first topic will introduce you to the field of international marketing. We concentrate first on the scope of international marketing, using several examples to illustrate that it is a broad

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process encompassing many firms and a wide range of activities. We then present definitions that will relate international marketing to other fields of study. In the next section, we examine the differences between domestic and international marketing and explain why domestic companies often have difficulty marketing abroad. The topic continues with a description of the major participants in international marketing.

11.1 Basics of International Marketing

When a business crosses the borders of a nation, it becomes complex.

International marketing involves all the activities that form part of domestic marketing. An enterprise engaged in international marketing has to correctly identify, assess and interpret the needs of the overseas customers and carry out integrated marketing operations to satisfy those needs. In other words, the basic functions are the same in international marketing as well as in domestic marketing.

At the same time, there are several characteristics that are unique to international marketing. When the business crosses the national borders of a given country, it becomes enormously more complex. The resulting problems and management situations transcend those of marketing, finance and production. A wide range of legal, political, cultural and sociological dimensions enter the picture, adding a lot of complexity to the task. And, the one factor that contributes maximum to the complexity is the environmental and cultural dynamics of the global markets.

11.1.1 Environmental and Cultural Dynamics of Global Markets

The environmental and cultural dynamics of the markets of different countries can be understood only by studying the respective people, their patterns of life, their tradition, their social interactions, their sensibilities, their faiths and fancies. In other words, the international marketer has to become a native in the foreign land. He has to communicate with the people of those lands in their lingo and idiom.

Multinational enterprise must function in a world of contrasts: old and new, primitive and modern, pious, and agnostic, unutterably beautiful and sickeningly squalid, educated and ignorant, progressive and stagnant, sophisticated and naive all in constant agitation. To interpret this volatile diversity, to make sense of this apparent chaos, we must try to identify the underlying forces the prime movers which produce the global dynamics.

It is obvious that the difference between domestic and international marketing is essentially environmental and cultural in character. And cultural diversity continues despite the world getting closer. Modern communication and transport systems have no doubt brought the nations of the world closer, but the cultural differences continue. So, understanding the cultural variances and nuances, and responding to them in a manner and style that is appealing to the foreign buyer becomes the crucial task. It is not enough if the international marketer communicates in the buyer's language. Language is only one aspect of culture. A national history, its social and religious heritage, the value system of its people, the code of conduct handed down through generations all these are components of a national culture. Moreover culture is not a static entity. It undergoes a continuous evolution. So, sizing up the cultural dynamics of the different markets of the world is quite a difficult exercise. And that explains the difficulty of international marketing.

Note International marketing and national marketing have almost same components but international marketing is much more complex.

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11.1.2 Main Functions in International Marketing

Let us briefly touch upon the main functions involved in International marketing. They are:

- Choosing the basic route for global marketing
- Market selection and product selection
- Selection of distribution channels
- Developing pricing strategy
- International marketing communication
- Mastering the procedural complexities
- Organizational adaptations
- Handling business ethics

Choosing the basic route:

A properly conceived entry strategy is the starting point. There are five basic routes to enter a foreign market:

- Exports
- Licensing of technology and know how
- Multinational trading
- Joint venture
- Full-fledged global operation

We shall mention the salient features of each of these routes.

Export is the primary route for entry into the global markets. Many firms stop with this step in their international marketing endeavor. Some firms, however, go beyond; they license their technology and know how to foreign firms who may be interested in importing it into their land. In multinational trading, the companies source products from any part of the world and cart it to any place where demand for the product exists. Setting up joint ventures in foreign countries is another effective strategy for gaining entry into world markets. Through the joint ventures, the firm literally gets close to the foreign markets. Through joint ventures, a firm becomes a native in foreign lands and that is the surest way to the birth of a full-fledged MNC. In modern days, the joint venture strategy is taking firmer roots among companies planning massive global marketing. Becoming full-fledged global operators or MNCs with manufacturing and marketing set up across countries is the most difficult but also rewarding of all strategies of International Marketing.

Task Make a list of main components of international marketing.

Self Assessment

Fill in the blanks:

1. ..... is the primary route for entry into the global markets.
2. Many firms stop with this step in their ..... marketing endeavour.
3. It is obvious that the difference between ..... and international marketing is essentially environmental and cultural in character.

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4. The international marketer has to become a native in the ..... land. He has to communicate with the people of those lands in their lingo and idiom.
5. International marketing involves all the ..... that form part of domestic marketing.
6. ..... enterprise must function in a world of contrasts.
7. Choosing the ..... route for global marketing is one of the main functions in International Marketing.

11.2 Scope of International Marketing

It is generally understood that a company like Boeing, the world's largest commercial airline manufacturer, engages in international marketing when it sells its aeroplanes to airlines across the globe. Likewise, Ford Motor Company, which operates large manufacturing plants in several countries, engages in international marketing even though a major part of its output is sold in the country where it is manufactured.

Today, however, the scope of international marketing has broadened and includes many other business activities. The activities of large department store chains, include a substantial element of importing. When these stores search for new products abroad, they practice another form of international marketing.

A whole range of service industries are involved in international marketing; many large advertising firms, banks, investment bankers, public accounting firms, consulting companies, hotel chains, and airlines now market their services worldwide.

International marketing encompasses some activities that only indirectly result in international transactions. A new breed of international marketer is illustrated by Carl Sontheimer, a retired engineer who in the mid-1970s was looking for a retirement activity. He visited a food fair in France and came across a food processor not yet found in the United States. He redesigned the machine, and it became a best seller in the United States under the Cuisinart brand name. By looking for new ideas outside his home market, Sontheimer was practicing a different type of international marketing one that has become a growth industry.

When Clark Equipment Company, a United States-based manufacturer of construction machinery, acquired Euclid, another U.S. firm, the idea was to add Euclid's heavy construction trucks to Clark's front-end loaders to improve Clark's position with its dealers in the United States. Many of these dealers had been approached by Komatsu, the leading Japanese construction equipment company and only second to Caterpillar worldwide. By adding Euclid trucks to its product line, Clark expected to check Komatsu's expansion in the United States. Consequently, what appeared like a domestic market move was actually aimed at a potential foreign competitor. Such competitive decisions are as much a part of international marketing as any examples cited earlier.

Example:

In international marketing, you have to customise. In US, Burger King add ham to burgers whereas in Paris, it add avocados on its burgers.

11.3 Definitions of International Marketing and International Marketing Management

Having examined the scope of international marketing, we are now able to define it more accurately. Any definition has to be built, however, on basic definitions of marketing and marketing management, with an added explanation of the international dimension. We

understand marketing as the performance of business activities directing the flow of products and services from producer to consumer. A successful performance of the marketing function by a firm is contingent upon the adoption of the marketing concept, consisting of (a) a customer orientation, (b) an integrated marketing organisation, and (c) customer satisfaction's Marketing management is the execution of a company's marketing operation. Management responsibilities consist of planning, organising, and controlling the marketing program of the firm. To accomplish this job, marketing management is assigned decision-making authority over product strategy, communication strategy, distribution strategy, and pricing strategy. The combination of these four aspects of marketing is referred to as the marketing mix.

For international marketing management, the basic aims of marketing and the responsibilities described above remain unchanged. What is different is the execution of these activities in more than one country. Consequently, we define international marketing management as the performance of marketing activities across two or more countries. We are now moving from single-country decisions to multi-country decisions. In some situations, only one or two countries are involved; in other situations, dozens of countries are involved simultaneously.

A firm exporting products to Malaysia is engaged in a marketing effort across two countries: the United States and Mexico. Another US firm operating a subsidiary in Malaysia that manufactures and markets locally under the direction of the Australian head office is also engaged in international marketing to the extent that the head office staff directs and supervises this effort. Consequently, international marketing does not always require the physical movement of products across national borders. International marketing occurs whenever marketing decisions are made that encompass two or more countries.

Task Determine and analyze the advantages of customer oriented business.

11.4 Relationships with Other Fields of Study

The field of international marketing is related to other fields of study. In its broadest terms, international marketing is a subset of international business, which is defined as the performance of all business functions across national boundaries. International business includes all functional areas such as international production, international financial management, and international marketing.

International trade theory, which explains why nations trade with each other, is a related concept. This theory is aimed at understanding product flows between countries, either in the form of exports or imports. An Australian. corporation exporting machinery to Japan would find its transactions recorded as an export in Australia whereas the same transaction would be treated as an import in Japan. In this situation, international marketing and international trade are concerned with the same phenomenon.

Should the same company produce its machinery in Japan and sell locally, however, there would be no exchange of goods between the two countries. Consequently, there would be no recognized international trading activity. However, as we have seen earlier, the company's decision to build machinery in Japan and sell it there would still be considered an international marketing decision. We can therefore conclude that international marketing goes beyond strict definitions of international trading and includes a wider range of activities.

International marketing should not be confused with foreign marketing which consists of marketing activities carried out by foreign firms within their own countries. Marketing by Brazilian firms in Brazil is therefore defined as foreign marketing and is not the principle focus of this book. However, Brazilian firms engaged in marketing their products in the United States

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are engaged in international marketing and are subject to the same concepts and principles as are U.S. firms marketing in Brazil.

Did u know? International Trade Theory also explain why products are exchanged between countries.

11.5 Determining International Marketing Strategies: Factors Limiting Standardisation

From an international marketing manager's point of view, the most cost-effective method to market products or services worldwide is to use the same program in every country, provided environmental conditions favour such an approach. However invariably, as we have seen in the previous section, local market characteristics exist that require some form of adaptation to local realities. One of the challenges of international marketing is to determine the extent of standardisation for any given local market. To do this, the international marketing manager must become aware of any factors that would limit standardisation. Factors limiting standardisation can be categorised into four major groups: market characteristics, industry conditions, marketing institutions, and legal restrictions.

Caution Product standardisation becomes difficult with regard to distinguished market variables and sustaining policies.

11.5.1 Market Characteristics

Market characteristics can have a profound effect on international marketing strategy. The physical environment of any country-determined by its climate, product use conditions, and population size often forces marketers to adjust products to local conditions. Many cars in Canada come equipped with a built-in heating system that is connected to an electrical outlet to keep the engine from freezing while turned off. In warmer climates, cars are not equipped with such a heating unit but are more likely to require air conditioning. The product use conditions for washing machines in Europe differ from country to country. In Germany, manufacturers have been forced to add built-in heaters because home makers prefer to boil the water during the regular washing cycle and use a coldwater fill. British home makers prefer to fill washing machines with hot water directly from a house boiler, making a built-in heating unit unnecessary. A country's population will affect the market size in terms of volume, allowing for lower prices in larger markets. Market size or expected sales volume greatly affect channel strategy. Company-owned manufacturing and distribution are often possible in larger markets, whereas independent distributors are often used in smaller countries.

Macroeconomic factors also greatly affect international marketing strategy. The income level, or gross national product (GNP) per capita, varies widely among nations-from below $100 for some of the world's poorest nations to above $10,000 for rich countries such as Kuwait, Sweden, and the United States. Depending on income level, countries have been categorised according to stages of economic development, ranging from a pre-industrial stage to full economic maturity." As can be expected, marketing environments will differ considerably according to income level. If the population's level of technical skill is low, a marketer might be forced to simplify product design to suit the local market. Pricing may be affected to the extent that countries with lower income levels show higher price elasticities for many products compared to developed countries. Furthermore, convenient access to credit is often restricted to buyers in developing

countries, impacting negatively on the sale of capital goods and consumer durables. Exchange rate fluctuations distort prices among countries for many products that otherwise might sell at similar prices. This leads to the problem of cross shipping products to take advantage of price gaps. With specialisation among channel members differing widely among various countries, depending on macroeconomic factors, companies often find themselves forced to adjust channel policies to compensate for the absence of the middleman they normally rely on in their home country. Wage levels and the availability of manpower may influence a company to choose a different approach for its sales force. Since the motivation to purchase some products depends on a country's income level, advertising and promotion strategy may have to be adjusted for such changes.

Cultural and social factors are less predictable influences on the marketing environment, and they have often frustrated many international marketers. Customs and traditions have the greatest effect on product categories when a country's population has had prior experience with a given product category. INCAP, an agency supported by several central American governments and located in Guatemala, developed a low cost, high protein beverage in the form of atole (thin gruel), a popular drink customarily consumed hot by Guatemalans. This same product was rejected by consumers in neighbouring El Salvador because the product would thicken when it was cool, which was the way El Salvadorians usually consumed Another hurdle in international marketing is language, which has become a major focus for international marketers. There are many examples of poor translations of promotional material. Pepsi Cola once used a literal translation of its popular U.S. campaign theme "Come Alive with Pepsi" in Germany without realising that come alive in German meant "come alive out of the grave.

11.5.2 Industry Conditions

Industry conditions often vary by country since products frequently are in varying stages of the product life cycle. New product introduction in a country without prior experience might affect the extent of product differentiation since only one or two versions of the product might be introduced initially. Also, a company might find itself in a situation where limited awareness or prior experience of a country will require a considerable missionary sales effort and primary demand stimulation, whereas in more mature markets the promotional strategy is likely to concentrate on brand differentiation. The level of local competition can be expected to vary substantially by country. The higher the technological level of the competition, the more an international company must improve the quality level of its products. The varying prices of local substitutes or low local production costs can be expected to influence pricing policy. In countries where competitors control channels and maintain a strong sales force, the strategy of a multinational company might differ significantly from that in a country where the company holds a competitive advantage.

11.5.3 Marketing Institutions

For historic and economic reasons, marketing institutions have assumed different forms in different countries. Practices in distribution systems often entail different margins for the same product, requiring a change in company pricing strategy. Availability of outlets is also likely to vary by country. Mass merchandisers such as supermarkets, discount stores and department stores are widely available in the United States and other industrialised countries but are largely absent in less developed nations in Southern Europe, Latin America and other parts of the world. Such variations may lead to considerably different distribution strategies. Likewise, advertising agencies and media are not equally accessible in all countries; and the absence of mass media channels in some countries makes a "pull" strategy less effective.

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11.5.4 Legal Restrictions

Legal restrictions also require consideration for the development of an international marketing strategy. Product standards issued by local governments must be observed. To the extent that they differ from one country to another, unified product design often becomes an impossibility. Tariffs and taxes may require adjustments in pricing to the extent that a product can no longer be sold on a high volume basis. Specific restrictions may also be problematic. In Europe, restrictions on advertising make it impossible to mention a competitor's name, despite the fact that such an approach may be an integral part of the advertising strategy in Australia.

To carry out the international marketing task successfully, international managers have to be cognisant of all the factors that influence the local marketing environment. Frequently, they need to target special marketing programs for each country.

Caution International managers should make themselves knowledgeable about legal issues of the host country, otherwise they could get into trouble.

11.6 Major Actors in International Marketing

Several types of companies are major participants in international marketing. Among the leaders are multinational corporations (MNCs), exporters, importers and service companies. These firms may be engaged in manufacturing consumer or industrial goods, in trading, or in the performance of a full range of services. What all participants have in common is a need to deal with the complexities of the international marketplace.

11.6.1 Multinational Corporations

Multinational corporations (MNCs) are companies that manufacture and market products or services in several countries. Typically an MNC operates a number of plants abroad and markets products through a large network of fully owned subsidiaries.

Although the United States is home to the largest number of MNCs, the first multinationals were of European origin and included firms such as Nobel and Alfa-Laval of Sweden, Unilever of the United Kingdom, Royal Dutch/Shell of the Netherlands, and Nestle of Switzerland. Some of the first U.S. companies to go multinational included Singer, which opened its first subsidiary in England in 1870, and NCR, Remington, Burroughs, Otis, and Westinghouse. Most of these companies possessed valuable patents that they wanted to protect from competition abroad. To cash in on their technological advantage, they opened branch plants in many European countries.

11.6.2 Service Companies

The early MNCs were largely manufacturers of industrial equipment and consumer products. Many of the newer MNCs are service companies. Commercial banks, investment bankers, and brokers have turned themselves into multinational service networks. Airlines and hotel companies have gained multinational status. Less noticeable are the multinational networks of public accounting firms, consulting companies, advertising agencies, and a host of other service related industries.

Did u know? USA is the home to largest number of MNCs in the world.

Examples of service companies with international involvement abound. McDonald's now gets close to 20 percent of its revenues from foreign operations, and almost 40 percent of its new outlets are foreign.

With some 7,000 restaurants in the United States and tough competition from other domestic chains, McDonald's expects most of its future growth to come from abroad.

11.6.3 Exporters

Exporters are firms that market products abroad but produce largely in their home country. Most large exporters have evolved into multinational companies. However, multinational companies, by shipping products between subsidiaries, have maintained some of the largest export operations.

11.6.4 Importers

As described earlier, importing is as much an international marketing decision as exporting. Companies that neither export nor have multinational status may still participate in international marketing through their importing operations. Many of the largest U.S. retail chains maintain import departments that are in contact with suppliers in many overseas countries. Other major importers are MNCs which source products from their own plants abroad or from other clients. Among the largest U.S. importers are oil companies and subsidiaries of foreign MNCs, particularly those of European and Japanese origin.

For the purpose of this subject, we will use international company or international firm as umbrella terms that may include MNCs, exporters, importers and service companies.

Note MNCs, exporters, importers and service companies operating on global scale are termed as "International Firms".

Self Assessment

Fill in the blanks:

8. ..... is the execution of a company's marketing operation.
9. ..... is a subset of international business, which is defined as the performance of all business functions across national boundaries.
10. ..... can have a profound effect on international marketing strategy.
11. ..... also greatly affect international marketing strategy.
12. ..... often vary by country since products frequently are in varying stages of the product life cycle.
13. ..... also require consideration for the development of an international marketing strategy.
14. ..... are companies that manufacture and market products or services in several countries.
15. Importing is as much an international marketing decision as ..... .

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11.7 Global Marketing Strategies

A global marketing strategy that totally globalizes all marketing activities is not always achievable or desirable (differentiated globalization). In the early phases of development, global marketing strategies were assumed to be of one type only, offering the same marketing strategy across the globe. As marketers gained more experience, many other types of global marketing strategies became apparent. Some of those were much less complicated and exposed a smaller aspect of a marketing strategy to globalization. A more common approach is for a company to globalize its product strategy (product lines, product designs and brand names) and localize distribution and marketing communication.

Integrated Global Marketing Strategy: When a company pursues an integrated global marketing strategy, most elements of the marketing strategy have been globalized. Globalization includes not only the product but also the communications strategy, pricing and distribution as well as such strategic elements as segmentation and positioning. Such a strategy may be advisable for companies that face completely globalized customers along the lines. It also assumes that the way a given industry works is highly similar everywhere, thus allowing a company to unfold its strategy along similar paths in country by country. One company that fits the description of an integrated global marketing strategy to a large degree is Coca-Cola. That company has achieved a coherent, consistent and integrated global marketing strategy that covers almost all elements of its marketing programme from segmentation to positioning, branding, distribution, bottling, advertising and more.

Reality tells us that completely integrated global marketing strategies will continue to be the exception. However, there are many other types of partially globalized marketing strategies; each may be tailored to specific industry and competitive circumstances.

Global Product Category Strategy: Possibly the least integrated type of global marketing strategy is the global product category strategy. Leverage is gained from competing in the same category country after country and may come in the form of product technology or development costs. Selecting the form of global product category implies that the company while staying within that category will consider targeting different segments in each category or varying the product, advertising and branding according to local market requirements. Companies competing in the multi-domestic mode are frequently applying the global category strategy and leveraging knowledge across markets without pursuing standardization. That strategy works best if there are significant differences across markets and when few segments are present in market after market. Several traditional multinational players who had for decades pursued a multi-domestic marketing approach tailoring marketing strategies to local market conditions and assigning management to local management teams- have been moving toward the global category strategy. Among them are Nestle, Unilever and Procter & Gamble, three large international consumer goods companies doing business in food and household goods.

Global Segment Strategy: A company that decides to target the same segment in many countries is following a global segment strategy. The company may develop an understanding of its customer base and leverage that experience around the world. In both consumer and industrial industries significant knowledge is accumulated when a company gains in-depth understanding of a niche or segment. A pure global segment strategy will even allow for different products, brands or advertising although some standardization is expected. The choices may consist of competing always in the upper or middle segment of a given consumer market or for a particular technical application in an industrial segment. Segment strategies are relatively new to global marketing.

Global Marketing Mix Element Strategies: These strategies pursue globalization along individual marketing mix elements such as pricing, distribution, place, promotion, communications or product. They are partially globalized strategies that allow a company that customize other

aspects of its marketing strategy. Although various types of strategies may apply, the most important ones are global product strategies, global advertising strategies and global branding strategies. Typically companies globalize those marketing mix elements that are subject to particularly strong global logic forces. A company facing strong global purchasing logic may globalize its account management practices or its pricing strategy. Another firm facing strong global information logic will find it important to globalize its communications strategy.

Global Product Strategy: Pursuing a global product strategy implies that a company has largely globalized its product offering. Although the product may not need to be completely standardized worldwide, key aspects or modules may in fact be globalized. Global product strategies require that product use conditions, expected features and required product functions be largely identical so that few variations or changes are needed. Companies pursuing a global product strategy are interested in leveraging the fact that all investments for producing and developing a given product have already been made. Global strategies will yield more volume, which will make the original investment easier to justify.

Global Branding Strategies: Global branding strategies consist of using the same brand name or logo worldwide. Companies want to leverage the creation of such brand names across many markets, because the launching of new brands requires a considerable marketing investment. Global branding strategies tend to be advisable if the target customers travel across country borders and will be exposed to products elsewhere.

Global branding strategies also become important if target customers are exposed to advertising worldwide. This is often the case for industrial marketing customers who may read industry and trade journals from other countries. Increasingly, global branding has become important also for consumer products where cross-border advertising through international TV channels has become common. Even in some markets such as Eastern Europe, many consumers had become aware of brands offered in Western Europe before the liberalization of the economies in the early 1990s. Global branding allows a company to take advantage of such existing goodwill. Companies pursuing global branding strategies may include luxury product marketers who typically face a large fixed investment for the worldwide promotion of a product.

Global Advertising Strategy: Globalized advertising is generally associated with the use of the same brand name across the world. However, a company may want to use different brand names partly for historic purposes. Many global firms have made acquisitions in other countries resulting in a number of local brands. These local brands have their own distinctive market and a company may find it counterproductive to change those names. Instead, the company may want to leverage a certain theme or advertising approach that may have been developed as a result of some global customer research. Global advertising themes are most advisable when a firm may market to customers seeking similar benefits across the world. Once the purchasing reason has been determined as similar, a common theme may be created to address it.

Composite Global Marketing Strategy: The above descriptions of the various global marketing models give the distinct impression that companies might be using one or the other generic strategy exclusively. Reality shows, however, that few companies consistently adhere to only one single strategy. More often companies adopt several generic global strategies and run them in parallel. A company might for one part of its business follow a global brand strategy while at the same time running local brands in other parts. Many firms are a mixture of different approaches, thus the term composite.

Caution Globalisation doesn't include product only, it is an holistic feature including pricing, communication, distribution etc.

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11.7.1 Competitive Global Marketing Strategies

Two types of approaches emerge as of particular interest to us. First, there are a number of heated global marketing duels in which two firms compete with each other across the entire global chessboard. The second, game pits a global company versus a local company- a situation frequently faced in many markets.

Global firms are able to leverage their experience and market position in one market for the benefit of another. Consequently, the global firm is often a more potent competitor for a local company.

Example: The competition between Coca Cola and Pepsico for marked dominance is famous for different global marketing strategies.

Although global firms have superior resources, they often become inflexible after several successful market entries and tend to stay with standard approaches when flexibility is called for. In general, the global firms' strongest local competitors are those who watch global firms carefully and learn from their moves in other countries. With some global firms requiring several years before a product is introduced in all markets, local competitors in some markets can take advantage of such advance notice by building defenses or launching a preemptive attack on the same segment.

Case Study

Siemens PLM Software Combines Global and Local with Eloqua's Marketing Automation

When you're selling complex software that helps companies innovate and build world-class products, consistency and clarity of marketing communications is a must. Maintaining that message consistency is a challenge for any company, but for Siemens PLM Software it's compounded by a large, global marketing organization that supports regional programmes across diverse geographies. The provider of Product Lifecycle Management (PLM) software needs to tell its story on a global scale, across multiple languages and in a way that is contextually relevant to a variety of different industry segments and international audiences.

For the Siemens PLM Software global marketing organisation, driving universal brand and message consistency was an elusive target. A one-size-fits-all marketing message didn't work across the myriad of challenges faced by customers and prospects and the unique requirements for each industry, region and regulatory compliance issues. While marketers in different countries and regions were enjoying moderate success with independent campaigns, their isolated marketing activities were spawning silos of customer data and preventing Siemens PLM Software from effectively building a consistent worldwide brand.

To make matters worse, the problem really couldn't be solved with the infrastructure in place at Siemens PLM Software a year ago. Marketers were primarily using e-newsletter and web design tools to orchestrate the company's diverse global marketing initiatives. The lack of automation made it next to impossible to choreograph communication with customers, let alone reuse and replicate messaging across different regions.

The Solution

To get more control over its global messaging, Siemens PLM Software decided to consolidate customer data and standardise on Eloqua's marketing automation platform.

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Using this unified platform, the various marketing teams would gain access to a shared set of customer and prospect data, universal campaign templates, website forms and marketing best practices that would ensure consistency of message. At the same time, Eloqua provided the flexibility Siemens PLM Software needed to tailor its messaging to meet the business requirements and special nuances of various global markets.

Eloqua's ability to automatically trigger any sequence of communications based on pre-defined rules enables Siemens to seamlessly execute their lead nurturing strategy and keep prospects engaged. These powerful automation capabilities also help the company efficiently orchestrate campaigns that are global in size and scope. A flexible forms engine helps ensure that relevant information is captured from customers without making it an onerous experience.

The Results

Siemens PLM Software's first major programme with Eloqua was comprised of a series of microsites, emails and search campaigns architected around the stages of a buyer's journey. The communications were aimed at both large enterprise prospects as well as small- and mid-sized companies. Visitors were prompted to register at different touch points to download customer case studies, analyst commentary or product information specific to their industry.

The scale and global nature of the campaign contributed to its complexity. The initiative spanned 22 global sites, each with its own language requirements. While the core brand and sequencing of the campaign remained consistent, Eloqua dynamically tailored messaging to meet language and content preferences of recipients. These preferences were continually refined with prospect profile and activity information captured by Eloqua forms and analytics.

As the team honed its skills and proficiency with Eloqua, it leveraged the product's advanced content management and workflow features to simplify execution and gain greater control when deploying massive, global campaigns. For example, through more efficient use of Eloqua forms, the team streamlined a global programme requiring hundreds of localized landing pages and forms down to just two forms – without sacrificing the personalisation critical to achieving high response rates.

Moreover, the team was able to scale back on the manpower required to orchestrate such an intricate campaign. A campaign that required field marketers in 30 countries to spend up to 100 hours localising and personalising content, can now be executed centrally in less than 10 hours.

Eloqua has also contributed greatly to increasing overall lead volumes and reducing the cost per lead from as high as $300 to less than $30. By centralising all lead capture tactics on a single, unified database and transitioning from events, conferences and seminars to digital marketing strategies, Siemens PLM has been able to develop more efficient, cost effective campaigns.

Most importantly, Eloqua ensures that all leads, independent of cost, are consistently acted upon in a personalized, targeted – but brand consistent – manner.

Questions

1. Enumerate the facts of the case and analyse them.
2. Do you think Siemens has adopted a great global marketing strategy? Comment.

Source: http://www.b2bmarketing.net/knowledgebank/international-marketing/case-studies/case-study-siemens-plm-software-combines-global-a

Notes

11.8 Summary

- International marketing involves all the activities that form part of domestic marketing.
- The environmental and cultural dynamics of the markets of different countries can be understood only by studying the respective people, their patterns of life, their tradition, their social interactions, their sensibilities, their faiths and fancies.
- Today, however, the scope of international marketing has broadened and includes many other business activities.
- A whole range of service industries are involved in international marketing; many large advertising firms, banks, investment bankers, public accounting firms, consulting companies, hotel chains, and airlines now market their services worldwide.
- A successful performance of the marketing function by a firm is contingent upon the adoption of the marketing concept, consisting of (a) a customer orientation, (b) an integrated marketing organisation, and (c) customer satisfaction's Marketing management is the execution of a company's marketing operation.
- In its broadest terms, international marketing is a subset of international business, which is defined as the performance of all business functions across national boundaries. International business includes all functional areas such as international production, international financial management, and international marketing.
- Factors limiting standardisation can be categorised into four major groups: market characteristics, industry conditions, marketing institutions, and legal restrictions.
- Several types of companies are major participants in international marketing. Among the leaders are multinational corporations (MNCs), exporters, importers, and service companies

11.9 Keywords

Exporters: These are firms that market products abroad but produce largely in their home country.

International Marketing Management: It is the performance of marketing activities across two or more countries.

International Trade Theory: This explains why nations trade with each other. It is aimed at understanding product flows between countries, either in the form of exports or imports.

Management Responsibilities: These consist of planning, organising and controlling the marketing programme of the firm.

Marketing Mix: This includes product strategy, communication strategy, distribution strategy, and pricing strategy. The combination of these four aspects of marketing is referred to as the marketing mix.

Mass Merchandisers: These include supermarkets, discount stores, and department stores.

Multinational Corporations (MNCs): These are companies that manufacture and market products or services in several countries.

11.10 Review Questions

1. Define international marketing.
2. Describe the environmental and cultural dynamics of global markets.

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3. Enumerate the main functions in International Marketing.
4. Explain the scope of International Marketing.
5. How are international marketing and international marketing management interrelated?
6. Explain the relationship of international marketing with other fields of study.
7. Enumerate the factors limiting standardization of international marketing strategies.
8. List the major actors in international marketing.
9. Write short notes on the various global marketing strategies discussed in this lesson.
10. "The basic functions are the same in international marketing as well as in domestic marketing. At the same time, there are several characteristics that are unique to international marketing." Comment.

Answers: Self Assessment

1.	Export	2.	International
3.	Domestic	4.	Foreign
5.	Activities	6.	Multinational
7.	Basic	8.	Marketing management
9.	International marketing	10.	Market characteristics
11.	Macroeconomic factors	12.	Industry conditions
13.	Legal restrictions	14.	Multinational corporations
15.	Exporting		

11.11 Further Readings

Books

Charles W.L. Hill, *International Business Competing in the Global Marketplace*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Chase Richard, Jacob Robert, Aquillano and Agarwal Nitin, *Operations Management,* 11th Edition, Tata McGraw-Hill Publishing Company Limited.

Justin Paul, *International Business,* (3rd ed.), Prentice Hall of India.

Online links

http://www.unescap.org/tid/artnet/mtg/competitivenesss_s7.pdf

http://www.londoninternational.ac.uk/sites/default/files/international-marketing-sample-study-guide.pdf

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Unit 12: Basics of International HRM

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Objectives

After studying this unit, you should be able to:

- Discuss the characteristics and nature of international HRM
- Describe the factors affecting IHRM, its functions and staffing policies

Introduction

In international business, the big challenge is putting the right person into the right job, in the right place at the right time for the right salary. This challenge is met by the international human resource management. HRM has an important strategic component for international business which reduces costs and adds value to the customers.

The need to have highly qualified people to staff the organization cannot be over emphasized. In this unit, factors affecting International Human Resource Management (IHRM), nature and structure of IHRM and staffing policy are discussed.

12.1 Basics of International HRM

International Human Resource Management (IHRM) is much broader in nature and scope in comparison to HRM.

According to John D. Daniels, "IHRM refers to the range of activities that a global company takes to staff its organization—determining its human resource needs, hire people to meet these needs,

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motivate them to perform well, upgrade their skills so to perform more challenging tasks and finally retaining them".

In the words of Cynthia D. Fisher, "The process of procuring, allocating and effectively utilizing human resource in an international business is called international human resource management".

International HRM, thus, involves ascertaining the corporate strategy of the company and assessing the corresponding recruitment, staffing and organizational strategy.

12.1.1 Characteristics of IHRM

The major characteristics of IHRM are as follows:

- Ascertaining the corporate strategy of the company and assessing the corresponding human resource needs.
- Involves determining the recruitment, staffing and organizational strategy at international level.
- It involves induction, training and motivating the personnel to perform well.
- It involves upgrading the skills of the personnel so that they may perform more challenging tasks at international level.
- The strategic role of HRM is more complex in an international business than that in domestic business.

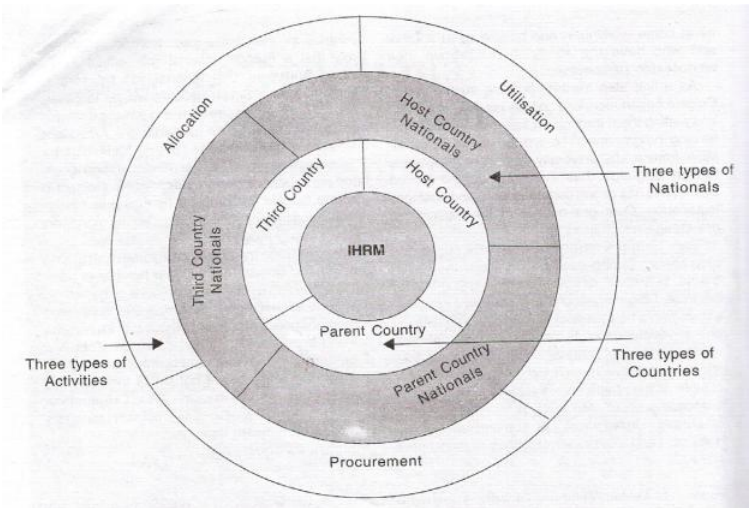
12.1.2 Nature of IHRM

IHRM involves the interplay among the three dimensions:

1. Human Resource Activities
2. Types of Employees
3. Countries of Operations

These dimensions reveal the nature of IHRM. It is also explained in the figure 12.1.

Figure 12.1: Model of International HRM



Source: Peter J. Dowling, IHRM, South Western College Publishing Co., 1999.

Notes

1. **Three Types of Activities:** The three broad activities of IHRM, namely, procurement, allocating, and utilizing, cover all the six activities of domestic human resources management (HRM). The six functions of domestic HRM are: human resource planning, employee hiring, training and development, remuneration, performance management, and industrial relations. These six functions can be dovetailed with the three broad activities of IHRM.

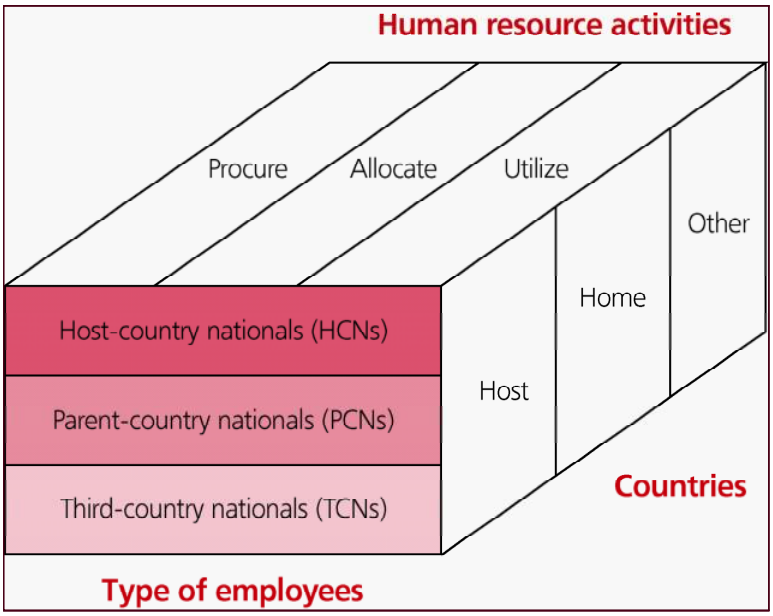
2. **Three Types of Countries:** The three national or country categories involved in IHRM activities are: the host-country where a subsidiary may be located, the home-country where the company is headquartered and 'other' countries that may be the source of labour or finance.

3. **Three Types of Employees:** The three types of employees of an international business include host-country nationals, parent-country nationals, and third-country nationals. Thus, for example, IBM employs Australian citizens in its Australian operations, often sends US citizens to Asia-Pacific countries on assignment, and may send some of its Singaporean employees of an assignment to its Japanese operations.

Note IHRM is same as HRM but on international scale.

An alternative approach to the model of IHRM is shown in the Figure 12.2.

Figure 12.2: A Model of IHRM – An Alternative Approach



- ***Host Country National (HCN):*** Belongs to the Country where the subsidiary is located
- ***Parent Country National (PCN):*** Belongs to the Country where the firm has its headquarters
- ***Third Country Nationals (TCN):*** Belongs to any other country and is employed by the firm.

Notes

12.1.3 Factors Affecting IHRM

According to Charles W.L. Hill, "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 in labour markets, culture, legal system, economic systems and the like".

The following are some of the important factors which make international HRM complex and challenging.

1. ***Differences in Labour Market Characteristics:*** The skill levels, the demand and supply conditions and the behaviour characteristics of labour vary widely between countries. While some countries experience human resource shortage in certain sectors, many countries have abundance. In the past, developing countries were regarded, generally, as pools of unskilled labour. Today, however, many developing countries have abundance of skilled and scientific manpower as well as unskilled and semiskilled labour. This changing trend is causing significant shift of location of business activities. Hard disk drive manufacturers are reported to be shifting their production from Singapore to cheaper locations like Malaysia, Thailand and China. While in the past unskilled and semiskilled labour-intensive activities tended to be located in the developing countries, today sophisticated activities also find favour with developing countries. The changing quality attributes of human resources in the developing countries and differentials are causing a locational shift in business activities, resulting in new trends in global supply chain management. India is emerging as a global R&D hub. India and several other developing countries are having large sources of IT personnel. In short, changing labour market characteristics have been causing global restructuring of business processes and industries. And this poses a great challenge for strategic HRM.
2. ***Cultural Differences:*** Cultural differences cause a great challenge to HRM. The behavioural attitude of workers, the social environment, values, beliefs, outlooks, etc. are important factors, which affect industrial relations, loyalty, productivity, etc. There are also significant differences in aspects related to labour mobility. Cultural factors are very relevant in inter-personal behaviour. In some countries it is common to address the boss Mr. so and so but in countries like India addressing the boss by name is not welcomed. In countries like India, people assign a great value to designations and hierarchical levels. This makes delayering and organizational restructuring difficult.
3. ***Differences in Regulatory Environment:*** A firm operating in different countries is confronted with different environments with respect to government policies and regulations regarding labour.
4. ***Attitude towards Employment:*** The attitude of employers and employees towards employment of people show variations among different nations. In some countries, hire and fire is the common thing whereas in a number of countries the ideal norm has been lifetime employment. In countries like India, workers generally felt that while they have the right to change organisations as they preferred, they had a right to lifetime employment in the organization they were employed with. In such situations, it is very difficult to get rid of inefficient or surplus manpower. The situation, however, is changing in many countries, including India.
5. ***Difference in Conditions of Employment:*** Besides the tenancy of employment, there are several conditions of employment the differences of which cause significant challenge to international HRM. The system of rewards, promotion, incentives and motivation, system of labour welfare and social security, etc. vary significantly between countries.

Task List various factors affecting IHRM.

Notes

12.2 HRM Functions

The main functions of HRM are as follows:

- Planning for Organizations, Jobs and People
  - The Strategic Management of Human Resources
  - Human Resource Planning
- Acquiring Human Resources
  - Selection
  - Recruitment
  - Integration
- Building and Motivating Performance
  - HR Development
  - Performance Appraisal
  - Compensation Systems
- Maintaining Human Resources
  - Benefits
  - Safety & Health
  - Collective Bargaining
  - Organizational Exit
  - Employment transitions
- Multinational Human Resource Management

12.2.1 Strategic Functions of IHRM

Research confirms and anecdotes suggest a powerful relationship between HRM process, management productivity and strategic performance. The following figure shows the strategic decisions and their implications for human resource management.

CEO and Chairman of General Electric once said, "Success is truly about people, not about where the buildings are. You have got to develop people so they are prepared for leadership jobs and then promote them. That is the most effective way to become more global".

The Chairman of Unilever in 1990 said, "The single most important issue for us has been and will continue to be, organization and people".

Research confirms these views, showing that superior human resources can sustain high productivity, competitive advantage and value creation for an international company.

1. ***High Productivity:*** On the basis of the Human Capital Index study, it was found that superior HR practices are positively correlated with the firm's financial returns. Hence, superior HRM was a stronger determinant of a firm's financial performance. Research shows that while executives acknowledge that the effectiveness of HR practices materially affects a firm's performance, many firms fail to achieve their HRM goals.
2. ***Competitive Advantage:*** A study of the role of HRM to enhance competitiveness at more than 300 multinationals reported that effectively developing HRM has positive effect on competitive advantage as through better HRM practices the right persons are placed in

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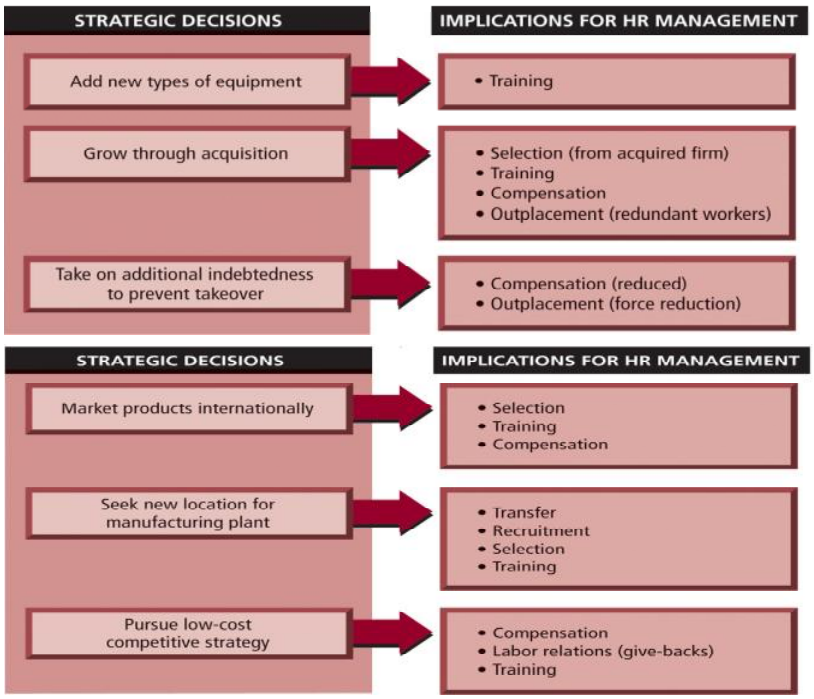
the right jobs in the right place at the right time for right salary. GE, in 1990s, globalizes its intellect seeking learning and transferring ideas throughout its global operations. This is transnational strategy which has been successful due to application of reused HRM philosophy.

3. ***Value creation for International Company:*** The Human Capital Index, based upon a comprehensive global study of over 2000 companies found that superior human resource practices were a leading indicator of increased shareholder value. This implies that superior IHRM system enhances the value for the international company.

Figure 12.3: Strategic Decisions and their Implications for HRM.



Task Explain briefly how better human resources can lead to better productivity.

12.3 Staffing Policies (Recruitment and Selection)

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. By corporate culture, we mean the organization's norms and value systems. A strong corporate culture can help a firm to 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 US 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.

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12.3.1 Types of Staffing Policy

Research identifies three types of staffing policies in international businesses: the ethnocentric approach, the polycentric approach, and the geocentric approach. We will review each policy and link it to the strategy pursued by a firm. The most attractive staffing policy is probably the geocentric approach, although there are several impediments to adopting it.

1. ***The Ethnocentric Approach:*** An ethnocentric staffing policy is one in which all key management positions are filled by parent-country nationals. This practice was very widespread at one time. Firms such as Procter & Gamble, Philips NV, and Matsushita 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. 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. According to the Japanese Overseas Enterprise Association, in 1996, 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.

   A firm pursues an ethnocentric staffing policy for three reasons:

   (i) The firm may believe that 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.

   (ii) The firm may see an ethnocentric staffing policy as the best way to maintain a unified corporate culture. Many Japanese firms, for example, prefer their foreign operations to be headed by expatriate Japanese managers because these managers have been socialized into the firm's culture while employed in Japan. Procter & Gamble until recently preferred to staff important management positions in its foreign subsidiaries with US nationals who had been socialized into P&G's corporate culture by years of employment in its US operations. Such reasoning tends to predominate when a firm places a high value on its corporate culture.

   (iii) If the firm is trying to create value by transferring core competencies to a foreign operation, 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 supporting the transfer with 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 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. 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 and 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 declining 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 host-country nationals.

Second, an ethnocentric policy can lead to "cultural myopia," the firm's failure to understand host country's 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 suspected simply because they do not understand the culture in which they are managing. 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 the behaviour that would be viewed as acceptable in Japan was not acceptable in the United States.

Did u know? It is still a widespread practice in MNCs, to fill key positions with home country nationals.

2. ***The Polycentric Approach:*** A polycentric staffing policy recruits host-country nationals 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 very 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 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 following 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.

3. ***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

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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. 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. Thus, other things being equal, a geocentric staffing policy seems the most attractive.

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 very 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.

12.3.2 Comparison of Staffing Approaches

The advantages and disadvantages of the three approaches to staffing policy are summarized in Table 12.1. 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.

Table 12.1: 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

Example: Electrolux for many years has attempted to recruit and develop a group of international managers from different countries to constitute a mobile base of managers.

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While the staffing policies described here are well known 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. 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 very broad geographic scope are the most likely to have a geocentric mind-set.

Note Geocentric staffing approach is always better as it is compatible with both global and transnational strategies.

Self-Assessment

Fill in the blanks:

1. A ..... staffing policy seeks the best people for key jobs throughout the organization, regardless of nationality.
2. Host-country nationals have limited opportunities to gain experience outside their own country and thus cannot progress beyond ..... in their own subsidiary.
3. The ..... that may result from a polycentric approach can also be a force for inertia within the firm.
4. Research identifies three types of staffing policies in ..... businesses: the ethnocentric approach, the polycentric approach and the geocentric approach.
5. A ..... staffing policy recruits host-country nationals to manage subsidiaries while parent-country nationals occupy key positions at corporate headquarters.
6. ..... National belongs to the country where the subsidiary is located
7. ..... National belongs to the country where the firm has its headquarters
8. ..... Nationals belongs to any other country and is employed by the firm.

12.3.3 Dependence on Expatriate Managers

Two of the three staffing policies we have discussed – the ethnocentric and the geocentric – rely on extensive use of expatriate managers. Expatriates are citizens of one country who are working in another country. Sometimes the term expatriates is used to identify a subset of expatriates who are citizens of a foreign country working in the home country of their multinational employer. Thus, a citizen of Japan who moves to the United States to work at Microsoft would be classified as an expatriate. 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. 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.

According to the Study of US, European and Japanese multinationals prepared by R.L. Tung for US multinationals, the reasons for higher expatriate failure, in order of importance, were

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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.

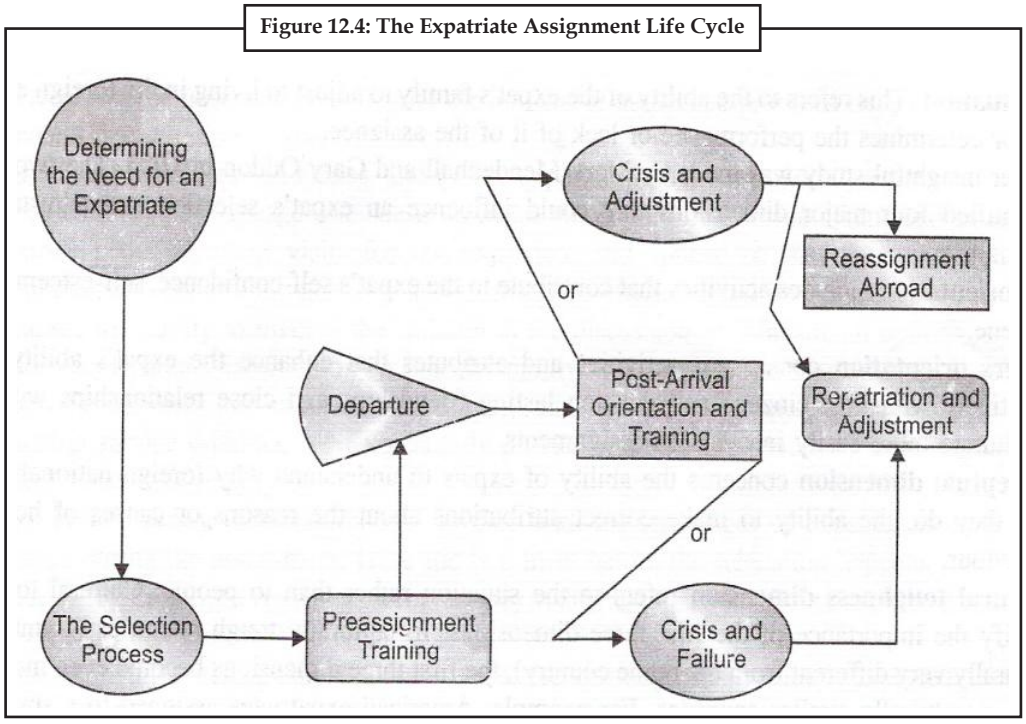
Caution Expatriate managers must consider the cultural dimensions of the host country.

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.

Figure 12.4 shows the model of the life cycle of an expatriate assignment which involves a process of determining the need for an expatriate assignment, selecting the candidates, pre assignments training, departure, post arrival orientation and training crisis and adjustment or crisis and failure, reassignment abroad or repatriation and adjustment.

Figure 12.4: The Expatriate Assignment Life Cycle



Source: Cynthia D Fisher, et al, Human Resource Management, Houghton Miffin, Co., 1997, p.781.

How to Reduce Expatriate Failure Rates?

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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. Domestic performance and overseas performance potential is 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-orientations, 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 the host country nationals, the more likely he or she is to succeed. Two factors, particularly, seem to be 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 more 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 an 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 non-judgmental and non-evaluative in interpreting the behavior of the 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 considered as 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. 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 are considered as particularly difficult postings for female managers.

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Self Assessment

9. ..... are citizens of one country who are working in another country.
10. With an ..... policy, the expatriates are all home-country nationals who are transferred abroad.
11. With a ..... approach, the expatriates need not be home-country nationals; the firm does not base transfer decisions on nationality.
12. ..... refers to the ability to develop long-lasting friendships with host-country nationals.
13. Willingness to communicate refers to the expatriate's willingness to use the host-country language.
14. ..... is the ability to understand why people of other countries behave the way they do; that is, the ability to empathize.
15. Although, language fluency helps, an ..... need not be fluent to show willingness to communicate.

Case Study

MOLEX Makes Global HR

Molex, a 70-year-old manufacturer of electronic components based in Chicago, is the world's second largest manufacturer of electronic components. The company established an international division to coordinate exporting in 1967, opened its first overseas plant in Japan in 1970 and a second in Ireland in 1971. From that base, Molex has evolved into a global business that generated about 61 percent of its $ 1.84 billion in revenues outside of the United States. The company operates some 50 manufacturing plants in 21 countries and employs more than 16,000 people worldwide, only one-third of who are located in the United States. Molex's competitive advantage is based on a strategy that emphasizes a combination of low costs, excellent customer service, and mass production of standardized products that are sold globally. Manufacturing sites are located in countries where cost conditions are favorable and major customers are close. Since the 1970s, a key goal of Molex has been to build a truly global company that is at home wherever in the world it operates and that proactively shares valuable knowledge across operations in different countries. The human resources function of Molex has always played a central role in meeting this goal.

As Molex grew rapidly overseas, the human resource management (HRM) function made sure that every new unit did the same basic things. Each new entity had to have an employee manual with policies and practices in writing, new employee-orientation programmes, salary administration with a consistent grading system, written job descriptions, written promotion and grievance procedures, standard performance appraisal systems that were written, and so on. Beyond these things, however, Molex views HRM as the most localized of functions. Different legal systems, particularly with regard to employment law, different compensation norms, different cultural attitudes to work, different norms regarding vacation, and so on-all imply that policies and programs must be customized to the conditions prevailing in a country. To make sure this occurs, Molex's policy is to hire experienced HRM professionals from other companies in the same country in which it has operations. The idea is to hire people who know the language, have credibility, know the law, and know how to recruit in that country.

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Molex's strategy for building a global company starts with its staffing policy for managers and engineers. The company frequently hires foreign nationals who are living in the United States, have just completed MBAs, and are willing to relocate if required. These individuals will typically work in the United States for a while, becoming familiar with the company's culture. Some of them will then be sent to their home country to work there. Molex also carefully screens its American applicants, favoring those who are fluent in at least one other language. Molex is unusual for a U.S. company in this regard. However, with more than 15 languages spoken at its headquarters by native speakers, Molex is committed to multilingual competency. There is also significant hiring of managers and engineers at the local level.

Here, too, a willingness to relocate internationally and foreign language competency are important, although this time English is the preferred foreign language. In a sign of how multinational Molex's management has become, it is not unusual to see foreign nationals holding senior positions at company headquarters. In addition to Americans, individuals of Greek, German, Austrian, Japanese, and British origin have all sat on the company's executive committee, its top decision-making body.

To help build a global company, Molex moves people around the world to give them experience in other countries and to help them learn from each other. It has five categories of expatriates: (1) regular expatriates who live in a country other than their home country for three-to-five-year assignments (there are approximately 50 of these at anyone time), (2) "inpats" who come to the company's U.S. headquarters from other countries, (3) third-country nationals who move from one Molex entity to another (for example, Singapore to Taiwan), (4) short-term transfers who go to another Molex entity for 6 to 9 months to work on a specific project, and (5) medium terms who go to another entity for 12 to 24 months, again to work on a specific project.

A high level of intracompany movement is costly. For an employee making $75,000 in base salary, the total cost of an expatriate assignment can run as high as $250,000 when additional employee benefits are added, such as the provision of schooling and housing, adjustments for higher costs of living, adjustments for higher tax rates, and so on. Molex also insists on treating all expatriates the same, whatever their country of origin, so a Singapore expatriate living in Taiwan is likely to be living in the same apartment building and sending his child to the same school as an American expatriate in Taiwan. This boosts the overall costs, but Molex believes that its extensive use of expatriates pays back dividends. It allows individuals to understand the challenges of doing business in-different countries, it facilitates the sharing of useful knowledge across different business entities, and it helps to lay the foundation for a common company culture that is global in its outlook.

Molex also makes sure that expatriates know why they are being sent to a foreign country, both in terms of their own career development and Molex's corporate goals. To prevent expatriates from becoming disconnected from their home office, the HRM department touches base with them on a regular basis through telephone, e-mail, and direct visits. The company also encourages expatriates to make home office visits so that they do not become totally disconnected from their base and feel like a stranger when they return. Upon return, they are debriefed and their knowledge gained abroad is put to use by, for example, placing the expatriates on special task forces.

A final component of Molex's strategy for building a cadre of globally minded managers is the company's in-house management development programs. These are open to a wide range of managers who have worked at Molex for three years or more. Molex uses these programs not just to educate its managers in finance, operations, strategy, and the like, but also to bring together managers from different countries to build a network of individuals who know each other and can work together in a cooperative fashion to solve business problems that transcend borders.

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Notes

Questions

1. What multinational strategy is Molex pursuing-localization, international, global standardization or transnational?
2. How would you characterize the approach to staffing used at Molex? Is this appropriate given its strategy?
3. Molex is very successful in its use of expatriate managers. Why do you think this is the case? What can be learned from Molex's approach?
4. How does the human resource function at Molex contribute to the attainment of its multinational strategy?

Sources: J. Laabs, "Molex Makes Global HR Look Easy," Workforce, March 1999, pp. 42-46; and M. Solomon, "Foreign Relations," Workforce, November 2000, pp. 50-56.

12.4 Summary

- International human resource management (IHRM) is much broader in nature and scope in comparison to HRM.
- International HRM, thus, involves ascertaining the corporate strategy of the company and assessing the corresponding recruitment, staffing and organizational strategy.
- There are various characteristics of international HRM
- IHRM involves the interplay among the three dimensions, namely IHRM involves the interplay among the three dimensions namely, human resource activities, types of employees and countries of operations.
- There are some important factors which make international HRM complex and challenging.
- Research confirms and anecdotes suggest a powerful relationship between HRM process, management productivity and strategic performance. There are certain strategic decisions and their implications for human resource management.
- Staffing policy is concerned with the selection of employees for particular jobs.
- Two of the three staffing policies we have discussed – the ethnocentric and the geocentric – rely on extensive use of expatriate managers.

12.5 Keywords

Bearer Bond: A bearer bond possession is evidence of ownership. The issue does not keep any records indicating who the current owner of a bond is.

Ethnocentric staffing policy: It is one in which all key management positions are filled by parent-country nationals.

Eurocurrency: Eurocurrency is the time deposit of money in an international bank located in a country different from the country that issued the currency.

Geocentric Staffing Policy: It seeks the best people for key jobs throughout the organization, regardless of nationality. This policy has a number of advantages.

Polycentric Staffing Policy: It recruits host-country nationals to manage subsidiaries while parent-country nationals occupy key positions at corporate headquarters.

Registered Bond: With registered bonds, the owner's name is on the bond and it is also recorded by the issuer.

Staffing Policy: It is concerned with the selection of employees for particular jobs.

Notes

12.6 Review Questions

1. What is international human resource management?
2. Discuss the main characteristics and nature of IHRM.
3. What are the factors affecting international human resource management?
4. Discuss the strategic functions of IHRM.
5. Discuss the different approaches to international staffing policy.
6. What are the important determinants of international staffing policy?
7. Compare and contrast between the different staffing approaches.
8. How can we reduce expatriate failure rates?
9. When does a firm pursue an ethnocentric staffing policy?
10. Enumerate the factors which make international HRM complex and challenging.

Answers: Self Assessment

1.	Geocentric	2.	Senior positions
3.	Federation	4.	International
5.	Polycentric	6.	Host Country
7.	Parent Country	8.	Third Country
9.	Expatriates	10.	Ethnocentric
11.	Geocentric	12.	Relationship development
13.	Willingness to communicate	14.	Perceptual
15.	Expatriate		

12.7 Further Readings

Books

Justin Paul, *International Business*, (3rd ed.), Prentice Hall of India.

Charles W L Hill, Arun K Jain, *International Business,* 2009, Tata McGraw Hill, New Delhi.

James H. Taggart and Michael C. Mcdormitt, *The Essentials of International Business,* Prentice Hall of India, 2000, p.34.

K. Aswathappa, *International Business,* 2009, Tata McGraw Hill, New Delhi.

Online links

http://www.cipd.co.uk/NR/rdonlyres/9A2ACF38-99A1-441A-99EA-BFE9BA6D6B0B/0/9781843981596sc.pdf

http://www.cefims.ac.uk/documents/sample-113.pdf

Notes

Unit 13: Basics of International Accounting and Financial Management

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Objectives

After studying this unit, you should be able to:

- Discuss about the concept of International Financial Management
- Describe the concept of International Accounting

Introduction

International marketing (IM) or global marketing refers to marketing carried out by companies overseas or across national borderlines. This strategy uses an extension of the techniques used in the home country of a firm. It refers to the firm-level marketing practices across the border including market identification and targeting, entry mode selection, marketing mix, and strategic decisions to compete in international markets. According to the American Marketing Association (AMA) "*international marketing is the multinational process of planning and executing the conception, pricing, promotion and distribution of ideas, goods, and services to create exchanges that satisfy individual and organizational objectives.*" In contrast to the definition of marketing only the word *multinational* has been added. In simple words international marketing is the application of marketing principles to across national boundaries. However, there is a crossover between what is commonly expressed as international marketing and global marketing, which is a similar term.

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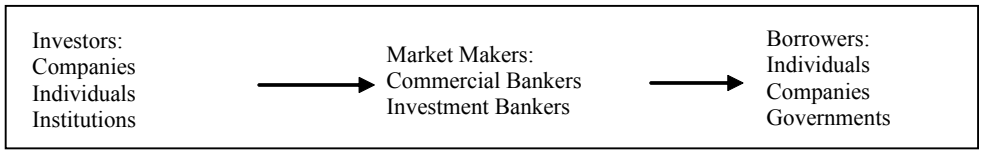
The intersection is the result of the process of internationalization. Many American and European authors see international marketing as a simple extension of exporting, whereby the marketing mix 4P's is simply adapted in some way to take into account differences in consumers and segments. It then follows that global marketing takes a more standardized approach to world markets and focuses upon sameness, in other words the similarities in consumers and segments.

13.1 Basics of International Financial Management

Here we discuss first the functions of the generic capital market followed by the limitations of a domestic capital markets and discuss the benefits of using global capital markets.

A capital market brings together those who want to invest money and those who want to borrow money.

Figure 13.1: The Main Players in a Generic Capital Market



Those who want to invest money include corporations with surplus cash, individuals, and non-bank 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. Citibank, US Bank Corp.) and investment banks (e.g. Merrill Lynch, Goldman Sachs).

Commercial banks perform an indirect connection function. They take cash deposits from corporations and individuals and pay them a rate of interest, making a profit from the difference in interest rates (commonly referred to as interest spread). Investment banks perform a direct connection function. They bring investors and borrowers together and charge commissions for doing so.

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. 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 (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 specified fixed stream of income from the corporation for a specified number of years (i.e. until the bond maturity date).

Notes

13.1.1 Features of Global Capital Market

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: A Lower Cost of Capital

In a purely domestic capital market, the pool of investors is limited to the residents of the country. This places an upper limit on the supply of funds available to the borrowers. A global capital markets, with its much larger pool of investors, provides a larger supply of funds for borrowers to draw on.

The important drawback of the limited liquidity of a purely domestic capital is that cost of capital market tends to be higher than it is in international market.

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 consequence is that investors can diversify their portfolios internationally thereby reducing their risk below that could be achieved in a purely domestic capital market. 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.

13.1.2 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. There seem to be two reasons for rapid growth-advances in information technology and deregulation by government.

Information Technology

Financial Services is an information-intensive industry. It draws on large volumes of information about markets, risks, exchange rates, interest rates, credit worthiness, 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 arrange of financial assets including corporate bonds, stocks, government securities and currencies.

The growth of international communication technology has facilitated instantaneous communication between any two points on the globe. At the same time, rapid advances in data processing have allowed market makers to absorb and process large volumes of information from around the world. With the rapid rise of 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 a trivial amount.

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.

Notes

Deregulation by Government

Financial services have been the most tightly regulated of all industries. Many of these restrictions have been crumbling since the early 1980s. In past, this has been a response to the development of Eurocurrency market, which forms the beginning, was outside of national control. It has also been a response to pressure from financial service 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 in a number of key countries have undoubtedly facilitated the growth of the international 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 restriction on inward investment by foreigners and outward investment by their own citizens and corporations.

13.1.3 The Eurocurrency Market

A Euro currency is the time deposit of money in an international bank located in a country different from the country that issued the currency. For example, Euro dollars are deposits of US dollars in banks located outside the US, Euro sterling are deposits of British pounds in banks outside UK, Euro Yen are deposits of Japanese yen in banks outside Japan. The prefix Euro is somewhat a misnomer since the bank in which deposit is made need not be located in Europe. The depository bank would be located in Europe, the Caribbean or Asia.

The origin of the Euro currency market can be traced back to the 1950's and early 1950's when the former Soviet Union and Soviet block countries sold gold and commodities to raise hard currency. Because of anti Soviet sentiment, these communist countries were afraid of depositing their US dollars in US banks for fear that the deposits could be frozen or infringed. Instead, they deposited their dollars in the French bank whose telex address was Euro-Bank. Since that time, dollar deposits outside the US have been called Euro dollars and banks accepting Euro currency deposits have been called Euro Bank.

The Euro currency market is an external banking system that runs parallel to the domestic banking system of the country that issues the currency. Both banking systems seek deposits and give loans to customers from deposit funds. In United States, banks are subject to the Federal Reserve recognition in specifying reserve requirements on time deposits. Additionally, US banks are required to buy FDIC insurance premium on deposit funds. Euro dollars are not subject to reserve requirements or deposit insurance, hence the cost of operations is less. The Euro currency market has grown spectacularly since its inception.

Caution Domestic banking system runs parallel to Euro currency market but differs in administration and system of banking.

Important Features

The important characteristics of the Eurocurrency market are the following:

1. ***International Market under no National Control:*** By its very nature the Eurodollar market is outside the direct control of any national policy. The growth of the market owes a great deal to the fact that it is outside the control of any national authority.
2. ***Short-term Money Market:*** The deposits in this market range in maturity from one day to several months and interest is paid on all of them. Although some Eurodollar deposits have a maturity of over one year. Eurodollar deposits are predominantly a short-term instrument.

Notes

3. ***Wholesale Market:*** The Eurodollar market is a wholesale market in the sense that the Eurodollar is a currency dealt in only large units.
4. ***Highly Competitive and Sensible Market:*** Its efficiency and competitiveness are reflected in its growth and expansion. The resiliency of the Eurodollar market is reflected in the responsiveness of the supply of and demand for funds in the changes in the interest rates vice versa.

Factors that Contributed to the Growth

The following are the important factors that have contributed to the growth of the Eurodollar market at different stages and times.

1. ***Suez Crisis:*** The restrictions placed upon sterling credit facilities for financing trade which did not touch the British shores during the Suez Crisis in 1957 provided a stimulus for the growth of the Eurodollar market. The British Banks in search of an alternative way to meet the demand for credit on the pat of the traders in this sphere, easily found a good substitute in dollars. There was already available a pool of US dollars, held by residents outside the US.
2. ***Relaxation of Exchange Controls and Resumption of Currency Convertibility:*** The general relaxation of exchange control, the stability in the exchange market and the resumption of currency convertibility in Western Europe in 1958 provided an added impetus to the growth of the Eurodollar market. In a convertible currency system, some countries are as a rule, in surplus and others in deficit. The money market in the surplus country being liquid, short-term funds flow to the Euro market, attracted by the higher rate of interest. On the other hand, credit flows from the euro market to the deficit countries where the money market is tight.
3. ***Political Factor:*** The cold war between the US and the communist countries also contributed to the growth of the Euro market. Due to fear of blocking or seizure of deposits by the US in the event of hostilities, the Russian and East European banks sought to place their dollar balances with European banks, especially British and French, rather than with banks in the US.
4. ***Balance of Payments Deficit of the US:*** The large and persistent deficit in the balance of payments in the US meant an increasing flow of the US dollar to those countries which had surplus with the US.
5. ***Regulation Q:*** Some of the regulations of the Federal Reserve System especially the Regulation 'Q' which fixed the maximum rate of interest payable by the banks in the US and the prohibition of payment of interest on deposits for less than 30 days very significantly contributed to the fast growth of the Euro market.
6. ***Innovative Banking:*** The advent of innovative banking, spearheaded by the American banks in Europe and the willingness of the banks in the market to operate on a narrow 'spread' also encouraged the growth of the euro market.
7. ***Supply of Petrodollars:*** The flow of petrodollars, facilitated by the tremendous increase in the OPEC's oil revenue following the hike in the oil prices in the 19732, has been a significant source of growth of the Eurodollar market.

Participants

Participants of the Eurocurrency business includes governments of all political categorizations, international organizations, central banks, commercial banks, corporations, especially multinational corporations, traders, individuals, etc.

Supply and Demand

The supply of and demand for funds in the Eurocurrency market come from the above participants. Central banks of various countries are very important suppliers. The bulk of the central bank funds are channelled through the BIS in Basle, Switzerland. The enormous oil revenue of the OPEC has become an important source of flow of funds to the Eurodollar market. Multinational corporations and traders place their surplus funds in the market to obtain short-term gains.

Governments have emerged as significant borrowers in the Eurocurrency market. The frequent hike in the oil prices and the consequent increase in the current account deficits of many countries compel them to increase their borrowings.

The commercial banks in need of additional funds for lending purposes may borrow from the Euro market and re-lend it. At the end of the financial year, sometimes they resort to borrowing for 'window dressing' also. Business corporations, especially multinationals, and traders borrow from the market for their short term requirements.

Evaluation of the Eurodollar Market

The advantages and dangers associated with the Eurocurrency market have given rise to the doubt whether it a welcome tonic or a slow poison to the international system.

Advantages: The growth of the Euro market has helped to alleviate the international liquidity problems considerably, provided credit to finance the balance of payments deficit, enabled the exporters and importers to obtain credit, helped to meet the short-term credit requirements of the business corporations and provide better opportunities for the investment of short-term funds. It has provided a market for profitable investment of funds by the central banks. The supply of funds by the Euro market has enabled commercial banks in some countries to expand domestic credit creation and helped 'window dressing'. The Eurocurrency has helped to accelerate the economic development of certain countries including South Korea, Brazil, Taiwan and Mexico.

Disadvantages: Despite the many advantages of the Eurodollar as a 'vehicle currency' for carrying on world trade and a source of international liquidity, there remains the unsettling prospect of a machine, controlled by no one, that can add to the world's money supply by creating dollars.

The Eurodollar and Eurobond markets become important sources of finance for governments and private firms. The growing integration of the world economy and globalization of business increase the importance of these markets.

Euro Market and India: Government of India has made use of the Euro market on several occasions. There is an increasing realization of the importance of this market by the Indian companies. The change in the business environment in India increases the importance of this market for Indian business.

Task How supply and demand affect the currency market.

13.1.4 Global Bond Market

A foreign bond issue is one offered by a foreign borrower to the investor in a national capital market and denominated in that nation's currency. As for example a German MNC issuing dollar denominated bonds to US investor.

A Euro bond issue is one denominated in a particular currency but sold to investors in national capital markets other than the country that issued the denominating currency. As for example,

Notes

an Indian borrower issuing dollar denominated bonds to the investor outside US say UK, Switzerland and the Netherlands.

The markets for foreign bonds and Euro Bonds operate in parallel with the domestic national bond markets and all three market groups compete with each other.

In any given year, it has been seen that over 85% of new international bonds are Euro bonds rather than foreign bonds. Euro bonds are known by the currency in which they are denominated, for example; US dollar Euro bonds, Yen Euro bonds and Swiss franc Euro bonds or correspondingly Euro dollar bonds, Euro Yen bonds and Euro SF bonds. Foreign bonds, on the other hand, frequently have colourful names that designate the country in which they are used. For example, Yankee bonds are dollar denominated foreign bonds originally sold to US investors, Samurai bonds are Yen denominated foreign bonds sold in Japan and bulldog are pound – sterling denominated foreign bonds sold in the UK.

Notes A Euro bond issue is one denominated in a particular currency but sold to investors in national capital markets other than the country that issued the denominating currency.

Bearer Bonds and Registered Bonds

Euro bonds are usually bearer bonds. A bearer bond possession is evidence of ownership. The issue does not keep any records indicating who the current owner of a bond is.

With registered bonds, the owner's name is on the bond and it is also recorded by the issuer. When a registered bond is sold, a new bond certificate is issued with the new owner's name or the new owner's name is assigned to the bond serial number.

US security regulation requires Yankee bonds and US corporate bonds sold to US citizens to be registered. Bearer bonds are very attractive to investors desiring privacy and anonymity. One reason is that they enable tax evasion. Consequently investors will generally accept a lower yield on bearer bonds than on registered bonds of comparable terms, making them a less costly source of funds for the issuer to service.

Foreign bonds to meet security regulation of a country in which they are used:

- For example, Yankee bonds must meet the same regulations as US domestic bonds. The US securities Act requires full disclosure of relevant information relating to a security issue. The expense of the registration process, the time delay it creates in bringing a new issue to the market, the disclosure of information that many foreign borrowers considered private have made it more desirable for foreign borrowers to raise the bonds in the Euro bond market.
- Same nations have imposed withholding tax on the interest which becomes cheaper to go for Euro bonds.

Global Bonds

A global bond issue is a very large international bond offering by a single borrower i.e. simultaneously sold in North America, Europe and Asia. Global bonds follow the registration requirements of domestic bonds but have the free structure of Euro bonds. Global bond offerings enlarge the borrowers' opportunities for financing at reduced costs. Purchasers, mainly institutional investment desire increased liquidity of the issue and are willing to accept lower yields.

Notes

Types of Debt Instruments

The international bond markets have been more innovative than the domestic bond market in the types of instruments offered to investors.

Straight Fixed Rate Issues

Straight fixed rate bond issues have a fixed maturity date at which the principal value of the bond is promised to be repaid. During the tenure of the bonds, fixed coupon payments which are a percentage of face value are paid as interest to the bond holders. In contrast, domestic bonds make semi-annual coupon payments. The reason is that Euro bonds are usually bearer bonds and annual coupon redemption is more conversant for the bond holders and less costly for the bond issuer since the bond holders are scattered geographically.

Floating Rate Notes

Floating Rate Notes (FRNs) are typically medium term bonds with coupon payments indexed to some reference rate. Coupon reference rates are either 3 months or 6 months.

Nations LIBOR. Coupon payment on FRNs is quarterly or semi annually and in accordance with the reference rate. For example, consider a five year FRN with coupon referenced to 6 months dollar LIBOR paying coupon interest semi annually. At the beginning of every 6 month period, the next semi annual coupon payment is reset to be 0.5 x (LIBOR + x percent) of face value, where x represents the risk premium over LIBOR. The issuer must pay based on its creditworthiness. As for example, if x equals 1/8 percent and the current 6 month LIBOR is 6.6 %, the next period coupon rates on a $1000 face value FRN will be 0.5 x (0.066 + .00125) x $1000 = $ 33.625. If on the next reset date six month LIBOR is 5.7%, the semi annual coupon will be set at 0.5 x (0.057 + 0.00125) x $1000 = $ 29.125.

Equity Related Bonds

There are two types of equity related bonds; convertible bonds and bonds with equity warrants.

A convertible bond allows the investor to exchange the bond for a predetermined number of equity shares of the owner. The floor value of a convertible bond is straight fixed rate bond value. Convertible usually sell at a premium above the straight debt value and their conversion value. Additionally, investors are usually willing to accept a lower coupon rate of interest than the comparable straight fixed coupon bond rate because of attractive terms of the conversion.

Bonds with equity warranty: can be viewed as straight fixed rate bonds with the addition of a call option (or warrant) feature. The warrant entitles the bond holder to purchase a certain number of equity shares of a pre stated price over a predetermined period of time.

Did u know? The convertible bond markets in the United States and Japan are of primary global importance. These two domestic markets are the largest in terms of market capitalization.

Zero Coupon Bonds

Zero coupon bonds are sold at a discount from face value and do not pay any coupon interest over the tenure. At maturity the investor receives the full face value. Alternatively, some zero coupon bonds originally sell for face value and at maturity the investor gets something for the use of the money.

Notes

Another form of zero coupon bond is stripped bonds. A stripped bond is a zero coupon bond that results from stripping the coupon and principal from a coupon bond. The result is a series of zero coupon bonds represented by individual coupon and principal payments.

Dual Currency Bond

A dual currency bond is a straight fixed rate bond issued in one currency say Swiss franc that pays coupon interest in the same currency. At maturity the principal is repaid in another currency say US dollars. Coupon interest is frequently at a higher rate than comparable straight fixed rate bonds. The amount of the dollar principal repayment at maturity is set at inception, the amount allows for same appreciation in the exchange rate of a stronger currency. From the investor's perspective, a dual currency bond includes a long-term forward contract. If the dollar appreciates over the life of the bond, the principal repayment will be worth more than the payment of the principal in Swiss francs. The market value of a dual currency bond in Swiss francs should equal the sum of the present value of the Swiss francs coupon stream discounted at the Swiss market rate of interest plus the dollar principal repayment, converted to Swiss francs at expected future exchange rate and discounted at the Swiss market rate of interest.

Corporate Currency Bonds

Corporate currency bonds are denominated in a currency basket. They are frequently called currency cocktail bonds. They are basically straight fixed rate bonds. A composite currency bond is an attractive type of financing for MNCs with sales receipts in a variety of currencies. From the international investors' standpoint, currency cocktail bonds are likely to have less exchange rate risk than bonds denominated in a single currency.

Summary of the typical characteristics of the international bond market instruments:

Investment	Frequency of interest payment	Pay off at maturity
Straight fixed rate	Annual	Currency of issue
Floating rate note	Quarterly or semi annual	Currency of issue
Convertible bond	Annual	Currency of issue or conversion to equity shares
Straight fixed rate with equity warrants	Annual	Currency of issue plus equity shares from exercise of warrants
Zero coupon bonds	None	Currency of issue
Dual currency bond	Annual	Dual currency
Composite currency bond	Annual	Composite currency of issue

Self Assessment

Fill in the blanks:

1. ..... with equity warranty: can be viewed as straight fixed rate bonds with the addition of a call option (or warrant) feature.
2. The ..... entitles the bond holder to purchase a certain number of equity shares of a pre stated price over a predetermined period of time.
3. ..... approach caters to segments within countries.
4. ..... banks perform an indirect connection function.
5. .....- loans to corporations are either equity loans or debt loans.

6. A ..... loan requires the corporation to repay a predetermined portion of the loan at regular intervals regardless of how much profit it is making.
7. A ..... market benefits both borrowers and investors.
8. Financial Services is an ..... industry.
9. ..... are deposits of US dollars in banks located outside the US.

13.1.5 International Bond and Market Credit Ratings

The credit rating organisation classifies bond issue into categories based on creditworthiness of the borrower. The ratings are based on analysis of current information regarding the likelihood of default and specification of debt obligation. The rating only reflects the creditworthiness and not exchange rate uncertainty. Fitch IBCA, Moody's Investor service and Standard and Poors (S&P) have for years provided credit ratings on domestic and international bonds. The rating agencies have rating categories 9 to 11 out of which the first 4 are regarded as investment grade ratings.

S&P also gives ratings for Sovereigns, Municipalities, Corporations, Utilities and Supranationals. In rating a sovereign government, S&P analysis centres around an examination of the degree of political risk and economic risk. In assessing political risk, S&P examines the stability of the political system, the social environment and international relations with other countries. Factors examined for assessing economic risk include the sovereign's external financial position, balance of payments flexibility, economic structure and growth, management of the economy, and economic prospects. The ratings assigned to a sovereign are particularly important because it usually represents the ceiling for rating. S&P will assign an obligation of an entity domiciled within that country.

International Bonds Market Indexes

The investment-banking arm of J.P. Morgan Company provides some of the best international bond market indexes that are frequently used for performance evaluation.

Did u know? J.P. Morgan publishes a domestic government index for 18 countries.

13.1.6 Global Equity Markets

Till 1970's, International Capital Markets focused on debt financing and equity finance was raised by corporate primarily in the domestic market due to the following:

- Restrictions on cross border equity investments prevailing until then in many countries.
- Investors also preferred to invest in domestic equity issues due to perceived risks in foreign equity issue due to foreign currency exposure or apprehensions of restrictions on such investments by the national authorities.
- Early 1980's because of liberalisation of many domestic economies, issue of dollar/foreign currency denominated equity shares were allowed to access international equity markets through the issue of an intermediate instrument called "Depository Receipts".

A Depository Receipt (DR) is a negotiable certificate issued by a depository bank which represents the beneficial investors in shares issued by a company. These shares are deposited with a local "custodian" appointed by the depository, which issues receipts against the deposit of shares.

According to the placements planned, DR's are referred to as (1) Global Depository Receipts (GDRs) (2) American Depository Receipts (ADRs) (3) International Depository Receipts (IDR).

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Each of the depository receipts represents a specified number of shares in the domestic markets usually in countries with Capital account convertibility, the GDRs and domestic shares are convertible (may be redeemed) mutually. This implies that, an equity shareholder may deposit the specified number of shares and obtain the GDR and vice versa. The holder of the GDR is entitled to a dividend in the value of the underlying shares of the GDR (issued normally in the currency of the investor country).

As far as Indian companies are concerned, dividends are announced as a percentage of the value of GDR same premium in rupees term converted at the prevailing exchange rate.

However until the GDR/ADR/IDR's are converted, the holder cannot claim voting rights and also there is no foreign exchange risk for the company. The company will be listed at the preferred stock exchanges providing liquidity for the investment.

Global Depository Receipts

The advent of GDRs in India has been mainly due to the balance payments crisis in the early 90s. At that time India did not have enough foreign exchange balance even to meet the requirements of fortnight imports. International institutions were not willing to lend because of non-investment credit rating of India. Out of compulsions, rather than choice, the government (accepting the World Bank suggestions on tiding over the financial predicament) gave permission to allow fundamentally strong private corporate to raise funds in international capital markets through equity or equity related instruments. The Foreign Exchange Regulation Act (FERA) was modified to facilitate investment by foreign investors up to 51% of the equity capital of the companies. Investments even beyond this limit are also being permitted by the government on a case to case basis.

Prior to this, companies in need of the foreign exchange component or resources for their projects had to rely on the government of India or partly on the government and partly on the financial institutions. These foreign currency loans utilised by the companies (whether through the financial institutions or through the government agency) were paid from the government allocation from the IMF, World Bank or other Governments credits. This in turn, created liability for the remittance of interest and principal, in foreign currencies which was to be met by way of earning through exports and other grants received by the government. However, with a rapid deterioration in the foreign exchange reserves consequent to the Gulf war and its subsequent oil crisis, companies were asked to get their own foreign currencies which led to the advent of GDRs.

Instrument

As mentioned earlier, GDRs are essentially those instruments which possess a certain number of underlying shares in the custodial domestic bank of the company. That is, a GDR is a negotiable instrument which represents publicly traded local-currency-equity share. By law, a GDR is any instrument in the form of a depository receipt or certificate created by the Overseas Depository Bank outside India and issued to non-resident investors against the issue of ordinary shares or foreign currency convertible bonds of the issuing company. Usually a typical GDR is denominated in US dollars whereas the underlying shares would be denominated in the local currency of the issuer. GDRs may be at the request of the investors-converted into equity shares by cancellation of GDRs through the intermediation of the depository and the selling of underlying shares in the domestic market through the local custodian.

GDRs, per se, are considered common equity of the issuing company and are entitled to dividends and voting rights since the date of their issuance. The company effectively transacts with only one entity – the overseas depository – for all the transactions. The voting rights of the shares are exercised by the depository as per the understanding between the issuing company and the GDR holders.

Notes

13.2 Basics of International Accounting

International Accounting can be described at three different levels:

- The influence on accounting by international political groups such as the OECD, UN, etc.
- The accounting practices of companies in response to their own international business activities.
- The differences in accounting standards and practices between countries.

13.2.1 International Transactions, FDI and Related Accounting Issues

Sale to foreign customer

- Most companies' first encounter with international business occurs as ***sales to foreign customers***.
- Often, the sale is made on credit and it is agreed that the foreign customer will pay in its own currency (e.g., Mexican pesos).
- This gives rise to ***foreign exchange risk*** as the value of the foreign currency is likely to change in relation to the company's home country currency (e.g., US dollars).

Example: Suppose that on February 1, 2006, Joe Inc., a U.S. company, makes a sale and ships goods to Jose, SA, a Mexican customer, for $100,000 (U.S.). However, it is agreed that Jose will pay in pesos on March 2, 2006. The exchange (***spot***) rate as of February 1, 2006 is 10.00 pesos per U.S. dollar. How many pesos does Jose agree to pay?

Solution: **Sale to foreign customer**

Even though Jose SA agrees to pay 1,000,000 Pesos ($100,000 x 10.00 pesos/U.S. $), Joe, Inc. records the sale (in U.S. dollars) on February 1, 2006 as follows:

Dr. Accounts receivable (+)	100,000	
Cr. Sales revenue (+)		100,000

Sale to foreign customer

Suppose that on March 2, 2006, the ***spot*** rate for pesos is 11 pesos/U.S. $). Joe Inc. will receive 1,000,000 pesos, which are now worth $90,909. Joe makes the following journal entry:

Dr. Cash (+)	90,909	
Dr. Loss on foreign exchange (+)	9,091	
Cr. Accounts receivable		100,000

13.2.2 Hedging

Joe can ***hedge*** (i.e., protect itself) against a loss from an exchange rate fluctuation. ***Hedging*** can be accomplished by various means, including:

Foreign currency option: The right (but not the obligation) to purchase foreign currency at a specific exchange rate for a specified period of time.

Forward contract: This is an obligation to exchange foreign currency at a date in the future, typically 30, 60 or 90 days.

Foreign Direct Investment (FDI): Occurs when a company invests in a business operation in a foreign country. This represents an alternative to importing to customers and/or exporting from

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suppliers in a foreign country. Two types of FDI are *Greenfield investment* and *acquisition*.

Greenfield investment: The establishment of a new operation in the foreign country.

Acquisition: Investment in an existing operation in the foreign country.

FDI Creates Two Primary Issues:

- The need to ***convert*** from local to U.S. GAAP since accounting records are usually prepared using local GAAP.
- The need to ***translate*** from local currency to U.S. dollars since accounting records are usually prepared using local currency.

International Income Taxation

- ***Foreign Income Taxes:*** The foreign government will tax the company's profits at applicable rates.
- ***U.S. Income Taxes:*** The U.S. will tax the company's foreign-based income.

International Transfer Pricing

- ***Transfer Pricing:*** Setting prices on goods and services exchanged between separate divisions within the same firm. These prices have a direct impact on the profits of the different divisions.
- **These exchanges are not arms-length transactions, thus giving rise to the certain problems in an international context:**
- ***Taxation:*** Governments in the various countries often scrutinize transactions to assure that sufficient profits are being recorded in that country.
- ***Performance evaluation issues:*** To the extent that division managers are evaluated based on divisional profits, transfer prices influence division manager performance evaluation.

13.2.3 International Auditing

Both internal and external auditors encounter differences that arise between auditing in an international vs. domestic context. These include:

- Language and cultural differences
- Different accounting standards (GAAP) and auditing standards (GAAS)

Cross-listing on Foreign Stock Exchanges

MNEs frequently raise capital outside their home country. When a company offers its shares on an exchange outside of its home country, this is referred to as *Cross-Listing*.

International Harmonization of Accounting Standards

The international movement towards a single set of worldwide accounting rules is referred to as *Harmonization*. International Accounting Standards (IAS) and U.S. GAAP are currently the two most important sets of accounting rules.

The Norwalk Agreement

- Published in 2002.
- Is a promise of cooperation in standard-setting between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB).
- Represents a significant step toward international harmonization.

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13.2.4 The Global Economy

Several indicators demonstrate the extent of business globalization:

- ***International trade:*** In 2001 exports worldwide topped $6 trillion. Between 1987 and 1999, U.S. exporters increased by 233% in number.
- ***Foreign Direct Investment:*** Between 1982 and 1999 worldwide FDI inflows increased from $58 billion to $865 billion.

Several indicators demonstrate the extent of business globalization:

- ***Multinational Enterprises (MNEs):*** Companies that have headquarters in one country and operate in one or more other countries. Currently, MNEs account for over one-quarter of the world's ***Gross Domestic Product (GDP)***.

Several indicators demonstrate the extent of business globalization:

- ***International Capital Markets:*** In 2001 there were 462 companies representing 53 countries cross-listed on the New York Stock Exchange (NYSE). In addition, over 60 U.S. companies are cross-listed on foreign exchanges.

Self Assessment

Fill in the blanks:

10. ..... per se, are considered common equity of the issuing company and are entitled to dividends and voting rights since the date of their issuance.
11. The ..... effectively transacts with only one entity – the overseas depository – for all the transactions.
12. The voting rights of the shares are exercised by the depository as per the understanding between the issuing company and the GDR ..... .
13. ..... refers to setting prices on goods and services exchanged between separate divisions within the same firm.
14. ..... is a negotiable certificate issued by a depository bank which represents the beneficial investors in shares issued by a company.
15. The credit rating organisation classifies bond issue into categories based on ..... of the borrower.

Case Study

McDonald's International HR

One of the best known companies worldwide is McDonald's Corporation. The fast food chain, with its symbol of the golden arches, has spread from the United States into 91 countries. With over 18,000 restaurants worldwide, McDonald's serves 33 million people each day. International sales are an important part of McDonald's business, and over 50 per cent of the company's operating income results from sales outside the United States. To generate these sales, McDonald's employs over one million people, and by 2000, McDonald's had grown to over two million employees.

Operating in so many different countries means McDonald's has had to adapt its products, services, and HR practices to legal, political, economic, and cultural factors in each one

Contd...

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of those countries. A few examples illustrate how adaptations have been made. In some countries, such as India, beef is not acceptable as a food to a major part of the population, so McDonald's uses lamb or mutton. To appeal to Japanese customers, McDonald's has developed teriyaki burgers. Separate dining rooms for men and women have been constructed in McDonald's restaurants in some Middle East countries.

HR practices also have had to be adapted. Before beginning operations in a different country, HR professionals at McDonald's research centre determine how HR activities must be adjusted. One method of obtaining information is to contact HR professionals from other US firms operating in the country and ask those questions about laws, political factors, and cultural issues. In addition, the firm conducts an analysis using a detailed outline to ensure that all relevant information has been gathered. Data gathered might include what employment restrictions exist on ages of employees and hours of work, what benefits must be offered to full-time and part-time employees (if part-time work is allowed), and other operational requirements. For instance, in some of the former communist countries in Eastern Europe, employers provide locker rooms and showers for their employees. These facilities are necessary because shower facilities, and even consistent water supplies, are unavailable in many homes, particularly in rural areas around major cities. Also, public transportation must be evaluated to ensure that employees have adequate means to travel to work.

Once a decision has been made to begin operations in a new country, the employment process must begin. Often, McDonald's is seen as a desirable employer, particularly, when its first restaurant is being opened in a country. For instance, in Russia, 27,000 people initially applied to work at the first Moscow McDonald's, which currently has over 1,500 employees. Because customer service is so important to McDonald's, recruiting and selection activities focus on obtaining employees with customer service skills. For worker positions such as counter representative and cashier, the focus is to identify individuals who will be friendly, customer service-oriented employees. A "trial" process whereby some applicants work for a few days on a conditional basis may be used to ensure that these individuals will represent McDonald's appropriately and will work well with other employees.

For store managers, the company uses a selection profile emphasizing leadership skills, high work expectations, and management abilities appropriate to a fast-paced restaurant environment. Once applicant screening and interviews have been completed, individuals are asked to work for up to a week in a restaurant. During that time both the applicants and the company representatives evaluate one another to see if the job "fit" is appropriate. After the first group of store managers and assistant managers are selected, future managers and assistant managers are chosen using international promotions based on job performance.

Once the restaurants are staffed, training becomes crucial to acquaint new employees with their jobs and the McDonald's philosophy of customer service and quality. McDonald's has taken its Hamburger University curriculum from the United States and translated it into 22 different languages to use in training centers throughout the world. Once training has been done for trainers and managers, they then conduct training for all employees selected to work at McDonald's locations in the foreign countries.

Questions

1. Identify cultural factors that might be important in a training programme for food handlers' at McDonald's in Saudi Arabia.
2. Rather than focusing on the differences, what similarities do you expect exist among McDonald's customers and employees in both the United States and abroad?

Source: Robert L. Mathis and John H. Jackson, Human Resource Management, South Western, 2000, Pp. 135-136

Notes

13.3 Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- The intersection is the result of the process of internationalization.
- Many American and European authors see international marketing as a simple extension of exporting, whereby the marketing mix 4P's is simply adapted in some way to take into account differences in consumers and segments.
- It then follows that global marketing takes a more standardized approach to world markets and focuses upon sameness, in other words the similarities in consumers and segments.
- The advent of GDRs in India has been mainly due to the balance payments crisis in the early 90s. At that time India did not have enough foreign exchange balance even to meet the requirements of fortnight imports. International institutions were not willing to lend because of non-investment credit rating of India.
- Out of compulsions, rather than choice, the government (accepting the World Bank suggestions on tiding over the financial predicament) gave permission to allow fundamentally strong private corporates to raise funds in international capital markets through equity or equity related instruments.

13.4 Keywords

Euro Currency: It is the time deposit of money in an international bank located in a country different from the country that issued the currency.

Foreign Currency Option: The right (but not the obligation) to purchase foreign currency at a specific exchange rate for a specified period of time.

Forward Contract: This is an obligation to exchange foreign currency at a date in the future, typically 30, 60 or 90 days.

Inter-market Segmentation: This involves the detection of segments that exist across borders.

International Marketing: It is the multinational process of planning and executing the conception, pricing, promotion and distribution of ideas, goods, and services to create exchanges that satisfy individual and organizational objectives.

Intra-market Segmentation: This involves segmenting each country's markets.

13.5 Review Questions

1. Critically examine the growth of the global capital market.
2. What are the features of global capital market?
3. What are the features of Eurocurrency market?
4. What are the different types of global bond market? Discuss each of them.
5. What do you understand by global equity market?
6. What are the instruments of global equity market?
7. Examine the factors which contributed to the growth of the Eurodollar market.
8. Enumerate the different types of debt instruments.
9. What are the advantages and dangers associated with the Eurocurrency market?
10. Write a short note on hedging.

Notes

Answers: Self Assessment

1. Bonds
2. Warrant
3. Micro
4. Commercial
5. Capital market
6. Debt
7. Global capital
8. Information-intensive
9. Euro dollars
10. GDRs,
11. Company
12. Holders
13. Transfer pricing
14. Depository Receipt
15. Creditworthiness

13.6 Further Readings

Books

Frederick D. S. Choi, Gary K. Meek, Frederick D. Choi, *International Accounting*, 7th Edition

Peter Walton, Bernard Raffournier, *International Accounting,* 1st Edition

Online links

http://www.clubresourcesinternational.com/media/28713/basic%20accounting%20&%20financial%20management.pdf

http://cga.nic.in/pdf/management_accounting.pdf

http://www.unf.edu/~dtanner/dtch/ch1.pdf

http://www.sgbau.ac.in/accounting-for-managers.pdf

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Unit 14: International Production and Logistics Management

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Objectives

After studying this unit, you will be able to:

- Discuss the international production management
- Learn the concept of international logistic management

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Introduction

We have described in earlier lesson that the environment in which international business competes include the different political, economic and cultural institutions found in nations. Our focus now shifts from the environment to the firm itself and in particular to the actions managers take to compete more effectively as an international business. We discuss how firms can increase their profitability by expanding their operations in foreign markets. We discuss different strategies that firms pursue when competing internationally, pros and cons of these strategies, the various factors that affect firms' choice of strategy and what practice firms adopt across various national markets.

As trade barriers fall and global markets develop many firms face a set of interrelated issues:

- Where the production facilities should be located, should it 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 risk and the like in order to minimize costs and maximize value added.
- 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 favourable location or is there value to maintain an operation at a given location even if underlying economic conditions change?
- Should the firm own production facilities, or it is better to outsource them to independent vendors?
- How should a globally dispersed supply change be managed and what is the role of Internet-based information technology in the management of global logistics?
- Should the firm manage global logistics itself, or should it outsource the management to enterprises that specialize in this activity?

14.1 International Production and Logistics Management

In this unit attempt has been made how these two functions be performed internationally to (1) lower the costs of value creation and (2) add value by better serving customer needs. It is also necessary to discuss the contribution made by information technology to these activities, which has become important in the era of internet.

Production may be defined as "the activities involved in creating a product". The term production denotes both service and manufacturing activities, since one can produce a service or produce a physical product. Production can be replaced with manufacturing. Materials management is the activity that controls the transmission of physical materials through the value chain, from procurement through production and into distribution. Materials management includes logistics, which refers to the procurement and physical transmission of material through supply chain, from suppliers to customers. Manufacturing and Materials management are closely linked, since a firms ability to perform its manufacturing function efficiently depends on a continuous supply of high-quality material inputs, for which materials management is responsible.

The manufacturing and materials management functions of an international firm have a number of important strategic objectives:

- One is to lower costs. Dispersing manufacturing activities to various locations around the globe where each activity can be performed most efficiently can lower costs. Costs can be lowered by managing the global supply chain efficiently so as to better match supply with 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.

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- Second strategic objective shared by manufacturing and materials management is to increase product quality by eliminating defective products from both the supply chain and the manufacturing process. The objective of reducing costs and increasing quality are not independent of each other. The firm that improves its quality control will also reduce its costs of value creation. Improved quality control reduces cost in three ways:
  - Increases productivity because time is not wasted manufacturing poor-quality products that cannot be sold, leading to a direct reduction in unit costs.
  - Lowers rework and scrap costs.
  - Lowers warranty costs.

Identifying the Target Audience: Even for the same product the target audience may be different in different countries. For example, bicycles are basic means of transportation in countries like India and the important category of consumers are small farmers, blue-collar workers and students. In some of the advanced countries, bicycles are used for sporting and exercising and hence the target audience is different.

The effect is to lower the costs of value creation by reducing both manufacturing and service costs.

The main management technique that companies are utilizing to boost their Product quality is Total Quality Management (TQM).

The growth of international standards has also focused greater attention on the importance of product quality.

In addition to the objectives of lowering costs and improving quality, two other objectives have particular importance in international business:

First, manufacturing and materials management must be able to accommodate demands for local responsiveness.

Second, manufacturing and materials management must be able to respond quickly to shifts in customer demand. In recent years time based competition has grown more important. When consumer demand is prone to large and unpredictable shifts, the firm that can adapt most quickly to these shifts will gain an advantage.

14.1.1 Where to Manufacture

An essential decision facing an international firm is where to locate its manufacturing activities to achieve the goals of maintaining costs and improving product quality. For the form contemplating international production, a number of factors must be considered which can be grouped under three broad headings: Country factors, technological factors and product factors.

Country Factors

The following needs to be focused:

- Difference in political economy and national culture influence the benefits, costs and risks of doing business in a country. A firm should locate its various manufacturing activities where the economic, political and cultural conditions.
- Differences in factor costs, certain countries have a comparative advantage for producing certain products.
- Role of location externalities in influencing foreign direct investment decisions. Externalities include the presence of an appropriately skilled labour pool and supporting industries. For example, because of cluster of semiconductor manufacturing plants in Taiwan, a pool of labour with experience in the semiconductor business has developed. In additions the

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plants have attracted a number of supporting industries, such as the manufacturer of semiconductor equipment and silicon, which have been established facilities in Taiwan to be near their customers.

- Formal and informal trade barriers influence location decision.
- Rules and regulations regarding direct foreign investment.
- Expected future movements in its exchange rate. Adverse changes in exchange rates can quickly alter a country's attractiveness as a manufacturing base. Example, many Japanese corporations had to grapple with this problem during the 1990s.
- Product's value to weight ration because of its influence on transportation costs.

Technological Factors

Here we are concerned with manufacturing technology, the technology that performs specific manufacturing activities. Three characteristics of manufacturing technology are of interest here–the level of fixed costs, the minimum efficient scale and the flexibility of technology:

Level of Fixed Costs

In some cases the fixed costs of setting up a manufacturing plant is so high that firm must serve the world market from a single location or from a very few locations. For example, it costs more than $ 1 billion to set up a state-of-the-art plant to manufacture semiconductor chips. Hence serving the world market from one single location makes sense.

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 productivity gains that come with specialization of employees within the plant. 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 input costs.

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 standard 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.

This view of production efficiency has been challenged by the rise of flexible manufacturing technologies. The term flexible manufacturing technology-or lean production-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. Flexible manufacturing technologies may actually allow the company to produce a wide variety of end products at a unit cost that at one time could only be achieved through the mass production of a standardized product, 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.

Notes

Note Mostly all MNCs have based their production units in South-East Asia due to very low labour costs.

Technology to reconcile two goals that were once though to be incompatible-low cast and product customization. Flexible manufacturing technologies vary in their sophistication and complexity. One of the famous examples of flexible manufacturing technology, Toyota's production system, is relatively unsophisticated but it has been credited with making Toyota the most efficient auto manufacturing in the world. Toyota's flexible manufacturing system was developed by one of the company's engineers, Ohno Taiichi. He observed numerous problem with the mass production system:

- *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*, long production runs because of initial machine settings were long resulted in the production of a large number of defects.
- *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 set-up times for production equipment (a major source of fixed costs). By using a system of levers and pullets he reduced the time required to change dies on stamping equipment from a full day in 1950 to 3 minutes by 1971. This made small production runs economical, which allowed Toyota to respond to customer demands for product diversity. Small production runs also eliminated the need to hold large inventories, thereby reducing warehousing costs. This allowed Toyota to produce a more diverse product range at a lower unit cost that was possible with conventional mass production.

  Flexible manufacturing cells are another common flexible manufacturing technology. It is a groping of various types of machinery, a common materials handler, and a centralized cell controller (computer). Each cell 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.

  Besides improving efficiency and lowering costs, flexible manufacturing technologies also enable companies to customize products to the unique demands of small consumer groups-at a cost that at one time could be achieved only by mass production of a standard product. Thus the technologies help a company achieve mass customization, which increases its customer responsiveness.

Self Assessment

Fill in the blanks:

1. ..... 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 standard output.
2. The ..... implicit in this idea is between unit costs and product variety.
3. Producing greater product variety from a ..... implies shorter production runs, which in turn implies an inability to realize economies of scale.

Notes

4. The growth of ..... has also focused greater attention on the importance of product quality.

Product Factors

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 manufacture these products in the optimal location and to serve the world market from there. The opposite hold 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 manufacture 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 and personal computers. Since there are few national differences in consumer taste and preference for such products, the need for local responsiveness is reduced.

14.1.2 Locating Manufacturing Facilities

There are two basic strategies for locating manufacturing facilities concentrating them in a centralized location and serving the world market from there, or decentralize them in various regional or national locations that are close to major markets. The appropriate strategic choice is determined by the various country, technological, and product factors and is summarized in the following table:

Table 14.1: Location Strategy and Manufacturing

Factors	Concentrated Manufacturing Favoured	Decentralized Manufacturing Favoured
Country Factors		
Differences in political economy	Substantial	Few
Differences in culture	Substantial	Few
Differences in factor costs	Substantial	Few
Trade barriers	Substantial	Few
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

Notes

In practice, location decisions are seldom clear-cut. For example, it is not unusual for difference in factor costs, technological factors, and product factors to point toward concentrated manufacturing while a combination of trade barriers and volatile exchange rates points towards decentralized manufacturing. For example, 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 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.

Caselet

Japanese Firm in China (Logistics Barriers to International Operations)

Foreign Direct Investment (FDI) to China has increased rapidly in recent years. In the 1990's, many foreign firms shifted their manufacturing base to China to utilize the cheap labor costs. Since China joined the WTO in 2000, an increasing number of foreign firms are entering China to take advantage of the business opportunities in the potentially huge market. Japan is a leading country in investments in China, and the FDI from Japan has increased from 137.7 billion Yen in 1998 to 670.0 billion Yen in 2008 (MOF, 2009). Joint Venture Enterprises (JVEs) and Foreign Investment Enterprises (FIEs) account for about 90 percent of all FDI in 2008. Additionally, Japanese firms tried to establish local suppliers instead of importing from home. Recent data shows that local supply has increased to 50 percent from 10 percent in 1995 (JCIPO, 2007).

Subsequently, there has been a rise in the distribution of materials and products in local markets. However, most of these firms encountered logistics problems in distributing their products in China. The reason for this is the development of the Chinese logistics industry has fallen behind the rapid economic growth and increased demand for distribution. As a result, some Japanese firms have begun to establish efficient logistics networks in their operations in China.

The Chinese government has begun to formulate logistics as a strategic industry and invested heavily in improving infrastructure, such as nationwide multi-modal transportation networks and large-scale logistics centers. The logistics barriers foreign firms encountered in China have been changing, and some new challenges have become concerns for the Japanese firms.

Logistics problems greatly affect the business operation and performance in a huge developing market such as China. Foreign firms in different industries are establishing effective logistics strategies in their operations in China due to the growing importance of China's economy. The continuous success of those firms in the Chinese market may depend on how well they deal with the problems encountered there.

The entry of foreign firms to the Chinese market will certainly encourage the development of the logistics industry, and will stimulate local logistics providers to learn and achieve logistics efficiency and modernize the logistics industry. It is important to recognize the challenges posed when entering the Chinese market and to anticipate how those issues can be improved and shaped in the future. The present study has identified that quality; cost and delayed delivery are seriously affected by logistics problems. Also, the logistics flow within China is where most problems regarding logistics arise in the entire business operation.

Notes

14.1.3 Strategic Role of Foreign Factories

Rationale behind establishing a foreign manufacturing facility evolves over time. Initially many foreign factories are established where labour costs are low. Their strategic role typically is to produce labour-intensive products at low cost as possible. For example beginning of 1970, many US firms in the computer and telecommunication equipment business established factories across Southeast Asia as Malaysia, Thailand and Singapore since these countries offered an attractive combination of low labour costs, adequate infrastructure and a favourable tax and trade regime. Initially the components produced by these factories were designed elsewhere and the final product would be assembled elsewhere. Overtime, however the strategic role of some factories have expanded, they have become important centres for the design and final assembly of products for the global marketplace. An example is Hewlett-Packard's operation in Singapore.

Such upward migration in the strategic role of foreign factories arises because many foreign factories upgrade their own capabilities. This improvement comes from two sources. First, pressure from the centre to improve a factory's cost structure and/or customize a product to the demands of customers in a particular nation can start a chain of events that ultimately leads to development of additional capabilities at that factory. Second, source of improvement to the capabilities of a foreign factory 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 1980s and 1990s. Their communication and transportation infrastructures and 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 no longer the case.

Self Assessment

5. An efficient manufacturing and ..... functions can improve an international business's competitive position.
6. The appropriate ..... choice is determined by the various country, technological and product factors
7. Rationale behind establishing a foreign manufacturing facility evolves over ..... .
8. Initially many foreign factories are established where labour costs are ..... .
9. Upward migration in the strategic role of foreign factories arises because many foreign factories ..... their own capabilities.

14.1.4 Make-or-buy Decisions

International businesses frequently face sourcing decisions:

- Decisions about whether they should make, or
- Buy the component parts that go into the final part.
- For example, in the automobile industry, the typical car contains more than 10,000 components, so automobile constantly face make or buy decisions.
- Make-or-buy decisions pose plenty of problems for purely domestic businesses but even more problems for international business.

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Advantages of Make

Lower costs-it may pay a firm to continue manufacturing a product or component par in-house if the firm is more efficient at that production activity than any other enterprise.

Facilitating specialized investments – 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.

Proprietary Product Technology Protection – Proprietary Product technology is a technology 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 this technology to fall into the hands of competitors.

Improved scheduling – the argument for vertical integration is that production cost savings result from it because it makes planning, coordination, and scheduling of adjacent processes easier.

Advantages of Buy

Strategic Flexibility: The greatest advantages of buying component parts 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.

Lower Costs: Vertical integration into the manufacture of component parts increases an organisation's scope and the resulting increase in organizational complexity can raise a firm's cost structure due to three reasons. First, the greater the number of sub-units in an organization, the greater is the problems of coordinating and controlling those units. Second, the firm that vertically integrates into component part manufacture may find that because its internal suppliers have a captive customer of the firm, they lack an incentive to reduce costs. Third, vertically integrated firms have to determine appropriate prices for goods transferred to subunits within the firm.

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.

14.1.5 Strategic Alliances with Suppliers

In order to reap the benefits of vertical integration without the associated operational problems by entering strategic alliances with essential suppliers. For example, an alliance between Kodak and Canon, under which Canon builds photocopiers for sale by Kodak and an alliance between Apple and Sony under which Sony builds laptop computers for Apple. Strategic alliances build trust between the firm and its supplier Trust is built when a firm makes a creditable commitment to continue purchasing from a supplier on reasonable terms. For example a firm may invest money in a supplier-perhaps by taking a minority share holding – to signal its intention to build a productive, mutually beneficial long-term relationship.

In general the trends toward just-in-time inventory systems (JIT), Computer-aided Design (CAD), and Computer-aided Manufacturing (CAM) seem 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.

14.1.6 Coordinating a Global Manufacturing System

Materials Management which encompasses logistics, embraces the activities necessary to get materials from suppliers to a manufacturing facility, through the manufacturing process, and

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out through a distribution system to the end user. The twin objectives of materials management are to achieve this 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 materials management is enormous. For a typical manufacturing enterprise, material costs account for between 50 and 70 per cent of revenues, depending on the industry. Even a small reduction in these costs will have a substantial impact on profitability.

Power of Just-in-Time

The basic philosophy behind just-in-time systems is to economise 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.

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 tide the firm over a shortages brought about by disruption among suppliers (such as labour disputes).

Role of Organization Structure

As the number and dispersion of domestic and foreign markets and source grow, the number and complexity of organizational linkages increase correspondingly in a multinational enterprise, the challenge of managing the costs associated with purchase, currency exchange, inbound and outbound transportation, production, inventory, communication, expediting, tariffs and duties and overall administration is massive.

Figure 14.1: Potential Materials Management Linkages

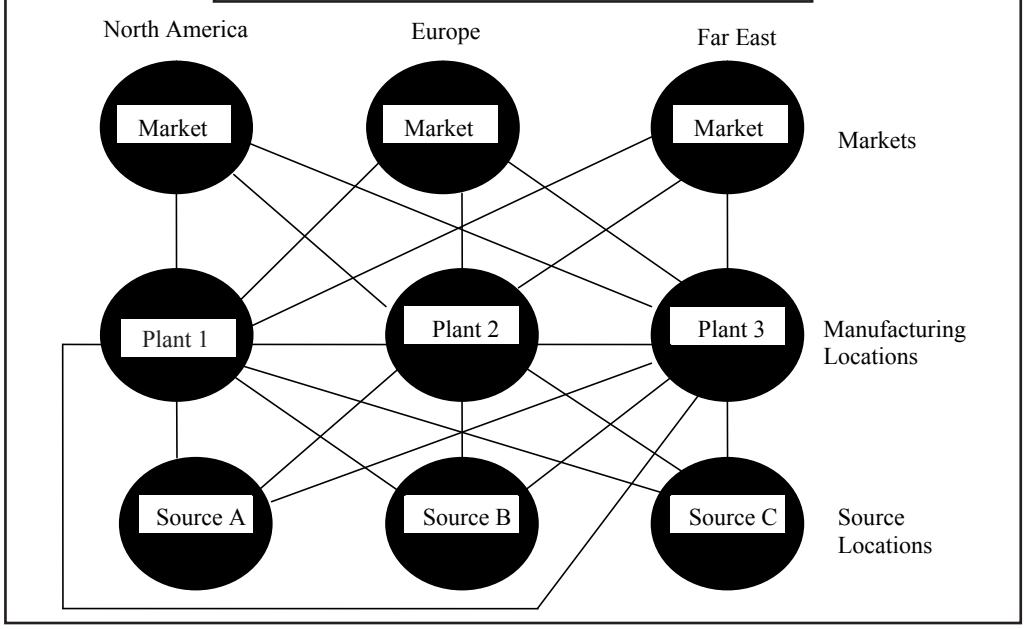

Figure 14.1 shows the linkages that might exist for a firm that sources, manufactures and sells internationally. Each linkage represents a flow of materials, capital, information, decisions and people. The firm must figure out the best organization to achieve tight coordination of the various stages of the value creation process.

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There are two ways of organising materials management as a business process:

- To separate out materials management as a function and give it equal weight in organizational terms, with other more traditional functions such as manufacturing, marketing and R&D. According to materials management specialists, purchasing, production, and distribution are not separate activities but three aspects one basic task: controlling the flow of materials and products from sources of supply through manufacturing and distribution into the hands of customers.
- Despite the apparent cost and quality control advantages of having a separate materials management function, all the firms do not operate with such a function. In such an organization, purchasing, production planning and control, and distribution are not integrated. Planning and control are part of the manufacturing function, while distribution is part of the marketing function. Such companies will be unable to establish materials management as a major strength and consequently may face higher costs.

The next dilemma is determining the best structure in a multinational enterprise. In practice, authority is either centralized or decentralized. Under a centralized solution, most materials management decisions are made at the corporate level, which can ensure efficiency and adherence to overall corporate objectives. This is the case at Dell Computer, for example. In large complex organizations with many manufacturing plants, however a centralized materials management function may become overloaded and unable to perform its task effectively. In such cases a centralized solution is needed.

A decentralized solution delegates most material management decisions to the level of individual manufacturing plants within the firms, although corporate headquarters retains responsibility for overseeing the function. The great advantage of decentralizing is that it allows Plant – level materials management groups to develop the knowledge and skills needed for interacting with foreign suppliers that are important to the respective plant, this can lead to better decision making. The disadvantage is that a lack of co-ordination between plants can result in less than optimal global sourcing. It can also lead to duplication of materials management efforts.

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 to word and assembly plant, information systems enable a firm to optimize its production scheduling based on time, components are expected to arrive by locating component parts in the supply change, good information systems allow the firm to accelerate production when needed by pulling key component out of the regular supply chain and having flown them to the manufacturing plant.

Firms increasingly use electronic data interchange to co-ordinate the flow of materials into manufacturing, through manufacturing and out to customers. EDI systems require computer links between a firm, its suppliers and its shippers. 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 use an EDI link to send invoices to the purchasing firm. The major advantage of an EDI system is that supplies, shippers, and the purchasing firm can communicate with each other with no time delay, which increases the flexibility and responsiveness of the whole supply chain. A second advantage is that major paperwork between suppliers, shippers, and the purchasing firm is eliminated Good EDI systems can help affirm decentralize materials management decisions to the plant level by giving corporate-level managers the information they need for coordination and control of the decentralized materials management groups.

Before the emergence of the Internet as a major communication medium, firms and their suppliers were required to buy 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

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proprietary solutions obsolete. Less expensive Web based systems are much easier to install and manage and they dominate the market for supply chain management software. These web-based systems are rapidly transforming the management of globally dispersed supply chains, allowing even small firms to achieve a better balance between supply and demand, thereby reducing the inventory in their systems and reaping the associated economic benefits.

Notes Web-based information systems play a crucial role in modern materials management by tracking component parts as they make their way across the globe to word and assembly plant, information systems enable a firm to optimize its production scheduling based on time, components are expected to arrive by locating component parts in the supply change, good information systems allow the firm to accelerate production when needed by pulling key component out of the regular supply chain and having flown them to the manufacturing plant.

14.2 Acquisition of Resources

Businesses operating in a foreign market can take advantage of the resources of the area, including natural and human resources. Business managers looking for an ideal location for an international branch should consider factors, such as property, raw materials, population and amenities. Many emerging markets create incentive programs designed to lure and assist foreign business.

14.3 Location Decisions

We have seen 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 us 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; and South Korea in the production of steel.

For a firm that is trying to survive in a competitive global market, it means 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.

Firms that pursue such a strategy can realize what we refer to as location economies, 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 in the optimal location for that activity can have one of the 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 the offerings of competitors.

14.3.1 Creating a Global Web

One can think of a creation of a global web of value creation activities, with different stages of the value chain being dispersed to those location around the globe where perceived value is maximized or where the costs of value creation are minimized. Consider the case of General Motors'. Marketed primarily in the United States, the car was designed in Germany; key components were manufactured in Japan, Taiwan and Singapore; assembly was performed in South Korea; and the advertising strategy was formulated in Great Britain. The car was designed

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in Germany because GM believed the designers in its German subsidiary had the skills most suited to the job at hand. (They were most capable of producing a design that added value.) Components were manufactured in Japan, Taiwan and Singapore because of favourable factor conditions – relatively low cost, skilled labour – suggested that those locations had a comparative advantage in the production of components (which helped the costs of value creation). The car was assembled in South Korea because GM believed that due to its low labour costs, the costs of assembly could be minimized there (also helping to minimize the costs of value creation). Finally the advertising strategy was formulated in Great Britain because GM believed a particular advertising strategy there was able to produce an advertising campaign that would help sell the car. (This decision was consistent with GM's desire to maximize the value added.)

Did u know? For a firm to survive in global market, it should base itself where factor costs are most conductive to its business.

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.

If transportation costs and trade barriers are introduced, the situation is somewhat complicated. Due to favourable 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.

The location of production facilities of a global corporation may be influenced by a number of factors.

14.3.2 Nature of Organization

The organizational model is a major determinant of the location. For example, in a Multinational Company, the subsidiaries do most of the production for their respective markets. In an International Company and Global Company, there is tendency to centralize core production activities in the home country. The transnational corporation is characterised by globally integrated networks of production facilities and other factors.

14.3.3 Cost

Given other factors (like political factors, organizational model and strategic-orientation etc.), the overall cost of operations is often the most important consideration in the location decision-making. Important factors, which determine the cost, include the following:

- ***Scale Economies:*** Where there are large-scale economies in production, production tends to concentrate in one or very limited number of locations. Such concentration may be in the home country or foreign countries.
- ***Nature of Assembly Operations:*** If there is large economies of scale in production of components and if the assembly operations are labour intensive, the locations of components manufacture and assembly operations could be different. The assembly operations may be carried out in countries where the labour is very cheap.
- ***Taxes and Transport Costs:*** The import duty structure also influences the location of production phases. If the import duty is very high on finished product and comparatively low on components it would encourage assembling of the product in the foreign market. If

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the cost of transporting the finished product is significantly higher than for the components, export in the CKD form would be preferred and the assembling of the product would be done in the foreign market. This will be particularly attractive if the labour is cheap in the foreign market. Sometimes the import duty and transport cost will favour the complete or most of the manufacturing activity in the foreign market.

Exchange Rate Variation

Exchange rate fluctuations may also influence the import vs. manufacturing decision. A depreciation of the foreign currency vis-à-vis the home currency will make imports into the foreign country costly and this may encourage production within the foreign market.

Availability and Cost of Inputs

Availability and cost of inputs (including land and infrastructure), obviously, are critical factors influencing the location decision. The infrastructure and other facilities and incentives are the attraction of export processing/special economic zones.

Factors

Certain locations are preferred because of logistical reasons the cost and ease of moving products to various markets. Some locations (Singapore, for example) are indeed regarded as the hub of international operations.

Government Policies and Regulations

Government regulations like foreign investment policy, environmental regulations, local content stipulations, labour laws, taxation, assistances and incentives, dividend policies, etc., influence the location.

Social and Political Factors

Social and political factors such as attitude towards foreign business, domestic harmony and peace, etc. also influence the location decision.

14.4 International Logistics Management

According to **John Daniels and Lee H. Radebaugh** an important dimension of the supply chain is logistics, also sometimes called materials management. It is the design and management of a system that controls the forward and reverse flow of materials, services, and information into, through, and out of the international corporation.

According to the **Council of Logistics Management, USA,** "logistics management is the "process of planning, implementing and controlling the efficient, cost effective flow and storage of raw materials, in-process inventory, finished goods, and related information from point of origin to point of consumption for the purpose of conforming to the customer requirements."

The difference between supply chain management and materials management is only of degree. Materials management, or logistics, focuses much more on the transport and storage of materials and final goods, whereas supply chain management extends beyond that to include the management of supplier and customer relations. It is an important component of operations management.

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14.4.1 Components of International Logistics

Logistics encompasses the total movement concept, covering the entire range of operations concerned with the movement of materials and products to, through, and out of the firm to the consumer. It includes a variety of activities such as inventory management, warehousing and storage, transportation, materials handling, order processing, distribution, communications, packaging, salvage and scrap disposal, returned goods handling, customer service, etc.

The various components of logistics are as under:

1. ***Fixed Facilities Location:*** The major consideration is the location of fixed facilities like production and warehousing in such a way as to maximize the total efficiency of the logistics system. Factors like future potential of the markets, future plans of the company, competitive factors and political stability are also important considerations.
2. ***Inventory Management:*** The main objective of inventory management is to minimize the cost of the inventory while ensuring smooth supplies. Developments in inventory management by the customers' order processing and in the total logistics system have made inventory management both challenging and efficient.
3. ***Order Processing:*** The efficiency of order processing by the client as well as the company has important implications for inventory levels and other aspects of the logistics. Rapid order processing shortens the order cycle and allows for lower safety stocks on the part of the client. Exporters from developing countries like India face the challenge of coping up with such situations.
4. ***Material Handling and Transportation:*** Material handling and transportation are also an important part of the logistics management. The technologies in use in material handling and transportation affect the efficiency of logistics.

Task Enumerate various components of international logistics.

Self Assessment

Fill in the blanks:

10. ..... encompasses the total movement concept, covering the entire range of operations concerned with the movement of materials and products to, through, and out of the firm to the consumer.
11. The difference between supply chain management and materials management is only of ..... .
12. ..... technology is a technology unique to a firm.
13. The drawback of a ..... system is that it leaves a firm without a buffer stock of inventory.
14. Firms increasingly use ..... to co-ordinate the flow of materials into manufacturing, through manufacturing and out to customers.
15. Where there are ..... economies in production, production tends to concentrate in one or very limited number of locations.

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14.4.2 Significance of Marketing Logistics

The importance of a logistics system lies in the fact that it leads to ultimate consummation of the sales contract. The buyer is not interested in the promises of the seller that he can supply goods at competitive price but that he actually does so. Delivery according to the contract is essential to fulfilling the commercial and legal requirements. In the event of failure to comply with the stipulated supply of period, the seller may not only get his sale amount back, but may also be legally penalized, if the sales contract so specifies. There is no doubt that better delivery schedule is a good promotional strategy when buyers are reluctant to invest in warehousing and keeping higher level of inventories. Similarly, better and/or timely delivery helps in getting repeat orders through creation of goodwill for the supplier.

Thus, as effective logistics system contributes immensely to the achievements of the business and marketing objectives of a firm. It creates time and place utilities in the products and thereby helps in maximizing the value satisfaction to consumers. By ensuring quick deliveries in minimum time and cost, it relieves the customers of holding excess inventories. It also brings down the cost of carrying inventory, material handling, transportation and other related activities of distribution. In nutshell, an efficient system of physical distribution/logistics has a great potential for improving customer service and reducing costs.

14.4.3 Scope of the Marketing Logistics

The development of interest in logistics after industrial revolution and World War II contributed to the growth in scope of logistical activities. The following areas are the major scope of logistics:

- Demand Forecasting
- Distribution Communication
- Inventory Control
- Material Handling
- Order Processing
- Part & Service Support
- Plant and Warehouse side selection
- Procurement
- Packaging
- Salvage & Scrap disposal
- Traffic & Transportation
- Warehousing & Storage
- Time & Place Utility
- Efficient Movement to Customer
- Return Goods Handling
- Customer Service

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14.4.4 Similarities and Differences between Domestics and Global Supply Chain Management

There are a lot of differences between domestics and global supply chain management. The following sections will cover them.

Similarities between Domestic and Global Supply Chain Management

Though the concept of supply chain management is same at the domestic and international level, when it comes to practice few similarities and differences are there. The similarities are:

- Conceptual framework
- Involve the movement and storage of products
- Role of information
- Quality monitoring
- Economic and safety regulations

Differences between Domestic and Global Supply Chain Management

The differences between domestic and global supply chain management are:

- Distance
- Language
- Cultural differences
- Currency
- Political stability
- Infrastructure

14.4.5 Information Technology and International Logistics

The Logistics Information System (LIS) is made up of the following information systems:

- Sales Information System [Ext.]
- Purchasing Information System [Ext.]
- Inventory Controlling [Ext.]
- Shop Floor Information System [Ext.]
- Plant Maintenance Information System [Ext.]
- Quality Management Information System [Ext.]
- Retail Information System (RIS) [Ext.]
- Transport Information System (TIS) [Ext.]

The information systems that belong to LIS have a modular structure, yet have a variety of techniques that allow you to evaluate data. This type of structure also allows the individual information systems to retain their special features.

The Logistics Information System allows you not only to evaluate actual data, but also to create planning data. The information systems provide easy-to-use planning functions that are

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also supported by a forecasting function. As of Release 3.0, the planning functionality of the information systems and the component Sales and Operations Planning (SOP) were combined and enhanced to make one central planning and forecasting tool.

One can use the Logistics Data Warehouse in Customizing to design the Logistics Information System to meet your own requirements. This tool allows you to customize the setup of the data basis for your information system, to define the rules for updating the data and to generate the standard analyses for evaluating the data.

The Early Warning System is integrated in all of the information systems and is based on the key figures of the information system. The Early Warning System supports the decision-making process by allowing you to target and monitor weak areas in logistics. It searches for exceptional situations and helps in the early detection and correction of undesirable situations.

The Logistics Information Library is a further component of the Logistics Information System. The Logistics Information Library makes it possible to access key figures in LIS by using simple search strategies. In addition, the Logistics Information Library allows you to catalog the key figures.

Task What services do freight forwarders provide?

14.5 Incoterms

When global companies enter into contracts to buy and sell goods they are free to negotiate specific terms. These terms include the price, quantity, and characteristics of the goods. Every international contract also contains what is referred to as an Incoterm, or international commercial term. The following incoterms are commonly used in international logistics:

14.5.1 Rules for any Mode of Transport

ExWorks (EXW): The seller fulfills his obligations by having the goods available for the buyer to pick up at his premises or another named place (i.e. factory, warehouse, etc.). Buyer bears all risk and costs starting when he picks up the products at the seller's location until the products are delivered to his location. Seller has no obligation to load the goods or clear them for export.

Free Carrier (FCA): The seller delivers the goods export cleared to the carrier stipulated by the buyer or another party authorized to pick up goods at the seller's premises or another named place. Buyer assumes all risks and costs associated with delivery of goods to final destination including transportation after delivery to carrier and any customs fees to import the product into a foreign country.

Carriage Paid To (CPT): Seller clears the goods for export and delivers them to the carrier or another person stipulated by the seller at a named place of shipment. Seller is responsible for the transportation costs associated with delivering goods to the named place of destination but is not responsible for procuring insurance.

Carriage and Insurance Paid To (CIP): Seller clears the goods for export and delivers them to the carrier or another person stipulated by the seller at a named place of shipment. Seller is responsible for the transportation costs associated with delivering goods and procuring minimum insurance coverage to the named place of destination.

Delivered at Terminal (DAT): Seller clears the goods for export and bears all risks and costs associated with delivering the goods and unloading them at the terminal at the named port or

place of destination. Buyer is responsible for all costs and risks from this point forward including clearing the goods for import at the named country of destination.

Delivered at Place (DAP): Seller clears the goods for export and bears all risks and costs associated with delivering the goods to the named place of destination not unloaded. Buyer is responsible for all costs and risks associated with unloading the goods and clearing customs to import the goods into the named country of destination.

Delivered Duty Paid (DDP): Seller bears all risks and costs associated with delivering the goods to the named place of destination ready for unloading and cleared for import.

14.5.2 Rules for Sea and Inland Waterway Transport

Free Alongside Ship (FAS): Seller clears the goods for export and delivers them when they are placed alongside the vessel at the named port of shipment. Buyer assumes all risks/costs for goods from this point forward.

Free on Board (FOB): Seller clears the goods for export and delivers them when they are onboard the vessel at the named port of shipment. Buyer assumes all risks/cost for goods from this moment forward.

Cost and Freight (CFR): Seller clears the goods for export and delivers them when they are onboard the vessel at the port of shipment. Seller bears the cost of freight to the named port of destination. Buyer assumes all risks for goods from the time goods have been delivered on board the vessel at the port of shipment.

Cost, Insurance, and Freight (CIF): Seller clears the goods for export and delivers them when they are onboard the vessel at the port of shipment. Seller bears the cost of freight and insurance to the named port of destination. Seller's insurance requirement is only for minimum cover. Buyer is responsible for all costs associated with unloading the goods at the named port of destination and clearing goods for import. Risk passes from seller to buyer once the goods are onboard the vessel at the port of shipment.

Case Study

Samsonite's Global Supply Chain

Samsonite Corporation is a US-based company that manufactures and distributes luggage all over the world. In fiscal year 2002, Samsonite generated $736.3 billion in revenues but incurred losses equal to $3.59 per share in 2002, $2.01 in 2001, and $2.53 in 2000. Samsonite was listed on the NASDAQ stock market, but it was delisted in January 2002 for failing to meet NASDAQ standards. Samsonite began in 1910 in Denver, Colorado, and it took many years for it to become a global company. In 1963, Samsonite set up its first European operation in the Netherlands and later, in 1965, began production in Belgium. Shortly thereafter, it erected a joint-venture plant in Mexico to service the growing but highly protected Mexican market. By the end of the 1960s, Samsonite was manufacturing luggage in Spain and Japan as well. In addition to its manufacturing operations, Samsonite was selling luggage worldwide through a variety of distributors.

In the 1970s, business began to take off in Europe. In 1974, Samsonite developed its first real European product, called the Prestige Attache, and business began to expand in Italy, causing it to rival Germany as Samsonite's biggest market in Europe. Although the US market began to turn to softside luggage in the 1980s, the European market still demanded hardside luggage, so Samsonite developed a new hardside suitcase for Europe called the Oyster case. Then softside luggage began to increase in importance, although Europe was

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still considered a hard side market. In the 1980s, Samsonite opened a new plant in France to manufacture the Prestige Attache and other key products.

With the fall of the Iron Curtain in the early 1990s, Samsonite purchased a Hungarian luggage manufacturer and began to expand throughout Eastern Europe. During the same time period, Samsonite established several joint-venture companies throughout Asia, including China, to extend its reach there. To produce high quality products, Samsonite embarked on two different programmes. The first was an internal program in which Samsonite conducted a drop test, a tumble test, a wheel test, and a handle test to determine if its products were strong enough and of sufficient quality for customers. The second programme consisted of two different, independent quality-assurance tests:

1. The European-based 'ISO 9002' certification
2. The GS Mark

The GS Mark, Gepruefte Sicherheit (translated "Tested for Safety"), is designed to help companies comply with European product liability laws as well as other areas of quality and safety. To enhance quality, Samsonite introduced state-of-the-art CAD-CAM machinery in its plants. Samsonite also introduced a manufacturing technique in which autonomous cells of about a dozen employees assembled a product from start to finish.

Samsonite had six company-owned production facilities and one joint-venture production facility in Europe in 2002. In addition, it has subsidiaries, joint ventures, retail franchises, distributors, and agents set up to service the European market. Although, Samsonite initially serviced the European markets through exports, the transportation costs were high, and the demand for luggage soared in Europe, so Samsonite decided to begin production in Belgium in 1965. In the early years, Samsonite had a decentralized supply chain, whereby it operated through different wholesale layers before it finally got the product to the retailers.

As Samsonite's business grew, management decided to centralize its supply chain so that products were manufactured and shipped to a central European warehouse, which then directly supplied retailers upon request. This centralized structure was put into place to eliminate the need to rely on wholesalers. Samsonite had to worry about transporting manufactured products to the warehouse, storing them, and transporting them to the retailers in the different European markets. Samsonite invested heavily in information technology to link the retailers to the warehouse and thereby manage its European distribution system more effectively. Retailers would place an order with a salesperson or the local Samsonite office in their area, and the order would be transmitted to the warehouse and shipping company by modem. The retail market in Europe began shifting at the turn of the new century, so Samsonite responded by opening franchised retail outlets in October 2002, beginning in Antwerp and spreading to other areas. As the vice president of marketing and sales put it, "We are anticipating a shift in the market, in which the traditional luggage channel will no longer be at the forefront and a wide new retail opportunity will emerge."

As noted earlier, Samsonite sold two basic types of suitcases: hardside and softside. Most of the R&D was initially done in the United States, but the need to develop products for the European market led the company to establish R&D facilities in Europe. Samsonite invested heavily in R&D and in the manufacture of specialized machinery to help keep a competitive edge. To facilitate the transportation and storage of suitcases, Samsonite located its production facilities close to the centralized warehouse. Softside luggage is less complex technologically, and Samsonite purchased Oda, the Belgium softside luggage company, to enter that market. Then, it licensed its technology to other European companies. By the mid-1990s, 48 percent of Samsonite's sales came from hardside luggage, 22 percent from

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softside, and 30 percent from attache cases and travel bags, some of which were hardside and some softside. However, the trend for hardside luggage in Europe is changing. By 2000, softside luggage comprised 51 percent of the European sales. In 2001 and 2002, sales of softside luggage continued to increase as a percentage, and hardside luggage sales declined.

As Samsonite expanded throughout the world, it continued to manufacture its own products and license production to other manufacturers. Then, Samsonite entered into subcontract arrangements in Asia and Eastern Europe. In Europe, the subcontractors provide final goods as well as the subassemblies used in Samsonite factories. Along with its own production, Samsonite outsourced parts and finished goods.

Samsonite is a good example of the challenges a firm faces in determining how best to manage the supply chain from supplier to consumer. The greater the geographic spread of the company, the more challenging the management of the supply chain becomes.

Questions

1. When Samsonite, a US based company, became a global company?
2. In which countries of Europe Samsonite began it operations?
3. What programme Samsonite designed to establish its products of high quality?
4. What were the expansion plans of Samsonite?
5. What was the R&D policy of Samsonite to keep a competitive edge?
6. What was the basic feature of its supply chain to meet the growing demand for the product of Samsonite?
7. What were the challenges faced by Samsonite to manage successfully the supply chain from supplier to customer?

Source: John D. Daniels, Lee H. Radebaugh & Daniel P. Sullivan, "International Business", Peterson Education, Singapore, p.561-563.

Case Study

Make or Buy Decision at the Boeing Company

The Boeing Company is the world's largest manufacturer of commercial jet aircraft with a 55 to 60 per cent share of the global market. Despite its large market share, in recent years, Boeing has found the going tough competitively. The company's problem is two fold. First, Boeing faces very aggressive competition from Europe's Airbus industry. The dog fight between Boeing and Airbus for market share has enabled major airlines to play the two companies off against each other in an attempt to bargain down the price for commercial jet aircraft. Secondly, several of the world's major airlines have gone through some very rough years during the 1990s and many lack the financial resources required to purchase a new aircraft. Instead, they are holding onto their used aircraft for much longer than has typically been the case. Thus, while the typical service life of Boeing 737 was once reckoned to be about 15 years, many airlines are now making the aircraft last as long as 25 years. This translates into lower orders for new aircraft. Confronted with this new reality, Boeing has concluded that the only way it can persuade cash-starved airlines to replace their used airlines with new aircraft is if it prices the aircraft very aggressively.

Thus, Boeing has had to face the fact that its ability to raise prices for commercial jet aircraft, which was once quite strong, has now been severely limited. Falling prices might even be

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the norm. If prices are under pressure, the only way Boeing can continue to make a profit is if it also drives down its cost structure. With this in mind, in the early part of the 1990s, Boeing undertook a companywide review of its make or buy decisions. The objective was to identify activities that could be outsourced to subcontractors, both in the United States and abroad to drive down its production costs.

While making these decisions, Boeing applied a number of criteria. First, Boeing looked at the basic economics of the outsourcing decision. The issue here was whether an activity could be performed more cost-effectively by an outside manufacturer or by Boeing. Secondly, Boeing considered the strategic risk associated with outsourcing an activity. Boeing decided that it would not outsource any activity that it deemed to be part of its long-term competitive advantage. For example, the company decided not to outsource the production of wings because it believed that doing so might give away valuable technology to potential competitors. Thirdly, Boeing looked at the operational risk associated with outsourcing an activity. The basic objective was to make sure that Boeing did not become too dependent on a single outside supplier for critical components. Boeing's philosophy is to hedge operational risk by purchasing from two or more suppliers. Finally, Boeing considered whether it made sense to outsource certain activities to a supplier in a given country to help secure orders for commercial jet aircraft from that country. This practice known as offsetting is common in many industries. For example, Boeing decided to outsource the production of certain components to China. This decision was influenced by the fact that current forecasts suggest that the Chinese will purchase over $100 billion worth of commercial jets over the next 20 years. Boeing's hope is that pushing some subcontracting work in China's way will help it gain a larger share of this market than its global competitor, Airbus.

One of the first decisions to come put of this process was the decision to outsource the production of insulation blankets for 737 and 757 aircraft to suppliers in Mexico. Insulation blankets are wrapped around the inside of the fuselage of an aircraft to keep the interior warm at high altitudes, Boeing has traditionally made these blankets in-house, but it found that it can save $50 million per year by outsourcing production to a Mexican supplier. In total, Boeing reckons that outsourcing cut its cost structure by $500 million per year between 1994 and 1997. By the time the outsourcing is complete, the amount of an aircraft that Boeing builds will have been reduced from 52 per cent to 48 per cent.

Questions

1. What are the main problems Boeing has been facing due to intense competition during 1990s?
2. What was the objective of Boeing to review its make or buy decision during 1990s?
3. What were the major considerations in making outsourcing decision by Boeing?
4. Why Boeing decided to outsource the production of certain components to China and Mexico?
5. What are the implications of outsourcing policy of Boeing?

Source: Charles W L Hill, International Business, p.517.

14.6 Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- A firm's strategy can be defined as the actions that mangers take to attain the goals of the firm. For most firms, the pre-eminent goal is to maximize long-term profitability. Maximizing profitability requires firms to focus on value creation.

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- Due to national differences, 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. This strategy is referred to as focusing on the attainment of local economies. By rapidly building sales value for a standardized product, international expansion can assist a firm in moving down the experience curve.
- International expansion may enable affirm to earn greater returns by transferring the skills and product offerings derived from its core competencies to markets where indigenous competitors lack those skills and product offerings.
- 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. The best strategy for a firm to pursue often depends on a consideration of the pressure for cost reductions and for local responsiveness.
- The lesson explained how efficient manufacturing and logistics functions can improve an international business 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 also examined closely at three issues central to international manufacturing and logistics management, where to manufacture, what to make and what to buy, and how to coordinate a globally dispersed and supply system.

14.7 Keywords

Economies of Scale: Cost advantages associated with large scale production.

Flexible Manufacturing Technology: Manufacturing technologies designed to improve job scheduling, reduce setup time, and improve quality control.

Global Strategy: Strategy focusing on increasing profitability by reaping cost reductions from experience curve and location economies.

International Strategy: Trying to create value by transferring core competencies to foreign markets where indigenous competitors lack those competencies.

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.

Multi-domestic Strategy: Emphasizing the need to be responsive to the unique conditions prevailing in different national markets.

Total Quality Management (TQM): Management philosophy that takes as its central focus the need to improve the quality of a company's products and services.

Trans-national Strategy: Plan to exploit experience-based cost and local economies, transfer core competencies with the firm, and pay attention to local responsiveness.

14.8 Review Questions

1. What is international logistics? Discuss its main components.
2. 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.

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3. Are the following global industries or multi-domestic industries: bulk chemicals, pharmaceuticals, branded food products, movie-making, television manufacture, personal computers, airlines travel?
4. Discuss how the need for control over foreign operations varies with the strategy and core competencies of a firm? What are the implications of this for the choice of entry mode?
5. What do you see as the main problems likely to be associated with implementation of a transnational strategy?
6. 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 work-force. 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 a firm adopt a concentrated or decentralized manufacturing strategy? What kind of location(s) should the firm favour for its plant(s)?
7. 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 moderate skilled work-force. 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. What kind of location(s) should the firm seek for its plant(s)?
8. A firm must decide whether to make a component part in-house or to contract out to an independent supplier. Manufacturing the plant requires a non-recoverable investment in specialized assets. The most efficient suppliers are located in countries with currencies that are expected to appreciate substantially over the nest decade. What are the pros and cons of (a) manufacturing the component in-house and (b) outsourcing manufacture to an independent supplier? What option would you recommend? Why?
9. Explain how information technology, particularly Internet data interchange, plays a major role in materials management?
10. What are the factors a firm contemplating international production should keep in mind? Elaborate each one of them.

Answers: Self Assessment

1.	Central	2.	Trade-off
3.	Factory	4.	International standards
5.	Material management	6.	Strategic
7.	Time	8.	Low
9.	Upgrade	10.	Logistics
11.	Degree	12.	Proprietary Product
13.	JIT	14.	Electronic data interchange
15.	Large-scale		

14.9 Further Readings

Notes

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Unit 15: Global Strategic Management and Business Ethics

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Objectives

After studying this unit, you should be able to:

- Learn the concept of global strategic management
- Discuss about the business ethics

Introduction

We have described in earlier units that the environment in which international business competes include the different political, economic and cultural institutions found in nations. Our focus now shifts from the environment to the firm itself and in particular to the actions managers take to compete more effectively as an international business. We discuss how firms can increase their profitability by expanding their operations in foreign markets. We discuss different strategies that firms pursue when competing internationally, pros and cons of these strategies, the various factors that affect firms' choice of strategy and what practice firms adopt across various national markets.

15.1 Global Strategic Management and Business Ethics

Global strategic management is a subset of strategic management, any definition of global strategic management has to be built on basic definitions of strategic management, with an added explanation of the global dimensions. So what are these global dimensions? We use the three differences between international strategy and global strategy to define global strategic management. Global strategy dimensions can be categorized into three main dimensions: the

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configuration and coordination, standardization, and integration dimensions. The discussion that follows describes the three sets of dimensions in more detail.

- The first major dimension of global strategy is coordination and configuration of the multinational firm's activities across countries. According to this view, global strategy is the process of exploiting the synergies that exist across different countries, as well as the comparative advantages offered by different countries (Zou and Cavusgil 2002). Comparative advantages offered by different countries include resources that are inherited-such as a country's location, climate, size, or stock of natural deposits-and resources that are the subject of sustained investment over a considerable period of time-such as a country's education system and specific skills, its technological and organizational capabilities, its communication and marketing infrastructures and its levels of labour productivity. According to the configuration and coordination perspective, multinational firms must configure their operations to exploit the benefits offered by different country locations, and coordinate their activities across countries to capture synergies derived from economies of scale and scope (Zou and Cavusgil 2002).
- The standardization dimension expressed by Levitt (1983) defines global strategic management as the process of offering products across countries. According to this view, multinational firms pursuing a standardization strategy have a global strategy, while multinational firms pursuing an adaptation strategy should be referred to as implementing an international strategy. It is important to note that for strategy to be global absolute standardization across countries is not necessary. Rather, it suffices if core elements of the product or service are applied consistently across countries with minor adaptations to local peculiarities. For example, IKEA offers its standard products worldwide but makes necessary adjustments to satisfy local customers and meet different legal standards.
- The third perspective is the integrations view. According to this view, global strategy is concerned with the integration of competitive moves across country markets (Zou and Cavusgil, 2002). Here, a firm makes competitive moves not because they are best for the particular country or region involved but because they are best for the firm as a whole. The ability of a firm to coordinate activities globally across markets depends on its ability to cross-subsidize, explicitly or implicitly, across markets. Yip (2002: 15) noted that in a global competitive strategy, competitive moves are made in a systematic way across countries, and that a competitor could be 'attacked in one country in order to drain its resources for another country, or a competitive attack in one country is countered in an-other country'.

Each of the above dimensions offers a partial explanation of global strategy. In this book we adopt a broad definition of global strategy that integrates the above three dimensions. We take it that the pursuance of one dimension does not preclude a multinational firm from pursuing another. A multinational firm may provide globally standard products, coordinate its activities globally, and integrate its competitive moves across countries simultaneously.

It must be noted that a global strategy is the process towards one, two, or all the three dimensions, as opposed to the extreme points of the perspective (Zou and Cavusgil, 2002). For a strategy to be global does not require absolute standardization across countries, complete coordination between countries, and fully integrated competitive moves.

15.2 Peculiarities of Global Strategic Management

A well designed global strategy can help a firm to gain a competitive advantage. This advantage can arise from the following sources:

- *Efficiency*
  - Economies of scale from access to more customers and markets
  - Exploit another country's resources-labor, raw materials

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- Extend the product life cycle-older products can be sold in lesser developed countries
- Operational flexibility-shift production as costs, exchange rates, etc. change over time

- ***Strategic***
  - First mover advantage and only provider of a product to a market
  - Cross subsidization between countries
  - Transfer price
- ***Risk***
  - Diversify macroeconomic risks (business cycles not perfectly correlated among countries)
  - Diversify operational risks (labor problems, earthquakes, wars)
- ***Learning***
  - Broaden learning opportunities due to diversity of operating environments
- ***Reputation***
  - Crossover customers between markets- reputation and brand identification

15.3 Value Creation

A firm's strategy can be defined as the actions that managers take to adopt the goals of the firm for most firms the goal is to maximize long term profitability. A firm makes a profit if the price it can charge for its output is greater that the cost of producing that output, profit (II) is defined as the difference between total revenue (TR) and total cost (TC) or

II = TR – TC

Total Revenue (TR) are equal to price (P) times the number of units sold by the firm (Q)

Or TR = P * Q

Total cost (TC) are equal to cost per unit (C) times the number of units sold or

LTC = C*Q

Total profit (II) is equal to profit per unit (II) times the number of units sold or

II = II * Q

Profitability is a ratio or a rate of return concept. A simple example would be rate of return on sales (ROS) which is defined as profit (II) over Total Revenue (TR) or

ROS = II / TR

Thus a firm might operate with a goal of maximizing its profitability as defined by its return on sales (ROS) and its strategy would be the actions that its managers take to attain this goal. A more common goal is to maximize the firms return on investment (ROI) which is defined as ROI = II / I where I represents the total capital invested in the firm.

Two basic conditions determine firms profit (II):

1. The value customers place on the firms goods or services and
2. The firms cost of production

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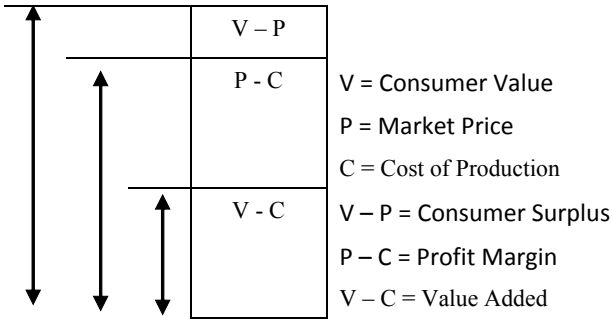
In general the more value customers place on firms products, the higher price the firm can charge for those products. However the price a firm charges for goods and services is typically less than the value placed by the customer on those goods and services. This is because the customer captures some of the value in the form of what economists call 'consumer's surpluses. The customer is able to do so because the firm is competing with other firms for the customer's business so the firm must charge a lower price than it could if it was 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 individual's assessment of the value of a product which economist's refer as 'customer's reservation price'.

This concept is illustrated in Figure 15.1.

Figure 15.1: Illustrates these Concepts



The value of product to a consumer is (V), the price that the firm can charge for that product given competitive pressures and its ability to segment the market is (P) and the cost of producing the product are (C).

The firms profit per unit sold (II) is P – C while the consumer's surplus is V – P. The firms make a profit so long as P>C and its profit will be greater the lower C is related to P.

The difference between V and P is determined by the intensity of competitive pressure in the market place. The lower the intensity of pressure the higher the price that can be charged relative to V.

The value created by a firm is measured by the difference between V and C (V-C); the company creates value by converting inputs that cost (C) into a product on which consumer's place a value of V. A company can create more value for its customers either by lowering production cost (C) or making the product more attractive through superior design, functionality, quality and the like so that consumer's place a greater value on it and consequently are willing to pay a high price. This discussion suggests that a firm has high profits when it creates more value for its customers and does so at lower costs.

Strategy can be referred to as that which focuses on lowering production costs as a low cost strategy. Similarly, strategy that focuses on increasing the attractiveness of the product can be called as a differential strategy. Michael Porter has argued that low cost and differential are two basic strategies for creating value and attaining a competitive advantage in an industry. According to Porter superior profitability is earned by 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 as compared to rivals does not necessarily require a firm to have a lowest cost structure in an industry or to create the most valuable product in the eyes of the consumers.

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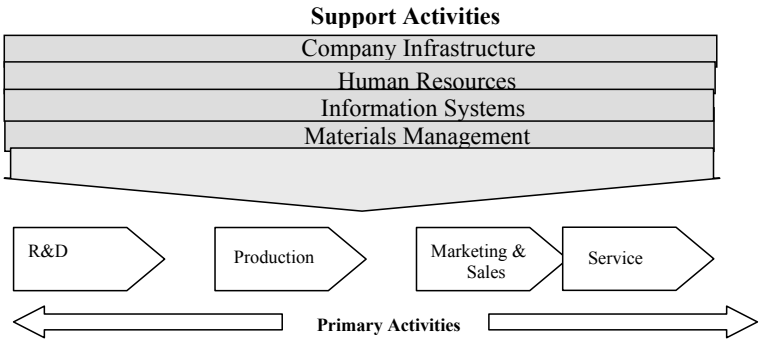
15.3.1 Firm as a Value Chain

Firm can be treated as a value chain composed of series of value creation activities including production, marketing, sales, materials management, R&D, human resources, information systems and the firms infrastructure. We can categorize their value creation activities as primary and support activities (see Figure 15.2).

Figure 15.2: The Value Chain Activities



15.3.2 Primary Activities

Primary activities have to do with the design, creation and delivery of the product; its marketing; its support and after sales service. In the value chain illustrated in figure 15.2 the primary activities are broken into 4 functions; R&D, production, marketing and sales and service.

Research & Development (R&D) is concerned with the design of products and production process. Although we think of R&D as being associated with the design of physical products and production process in manufacturing enterprises, many service companies also undertake R&D.

Example: Banks compete with each other by developing new financial products and the new ways of delivering those products to customers. Online banking and smart debit cards are two recent examples of new product development in the banking industry.

Through superior product designs, 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 process thereby lowering production costs (lowering C). Either way the R&D functions and creates value.

Caution R&D is only associated with the design of products and production process and not the design of physical products and its process of production.

Production is concerned with the creation of good or service. For physical products production generally means manufacturing. For services such as banking or retail operations production occurs when the service is delivered to the customer (for example, when a bank originates a loan for a customer it is engaged in the production of the loan). The production activity of a firm creates value by performing its activities efficiently with lower costs (lower C) or by performing them into a more reliable and higher quality product (which results in higher V).

The marketing and sales function of a firm can create value in several ways. Through brand positioning and advertising the marketing function can increase the value (V) that consumers perceive in a firms product. If these create a favourable impression of the firms' product

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in the minds of consumers they increase the price that can be charged for the firms product. For example, in the 1980s the French Company Perrier did a wonderful job of US consumers that slightly carbonated bottled water was worth US $ 1.50 per bottle rather than price closer to US $ 0.50 that it cost to physically collect, bottle and distribute the water. Perrier's marketing function increased the perception of value (V) that consumer's ascribed to the product. Marketing and sales can also create value by discovering consumer needs and communicating back to the R&D function of the Company which can design products to match those needs.

The role of service activity is to provide after sales services and support. This 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. This is an extremely valuable capability in an industry where down time is very expensive. For example Caterpillar the US based manufacturer of heavy earth moving equipment can get spare parts to any point in the world within 24 hours thereby minimizing the amount of downtime its customer's have to suffer if their Caterpillar equipment malfunctions.

Caselet

Global Cost Structure Analysis

In 1986, Whirlpool Corporation was considering expanding into Europe by acquiring Philips' Major Domestic Appliance Division. From the framework of customers, costs, competitors, and government, there were several pros and cons to this proposed strategy.

Pros

- Internal components of the appliances could be the same, offering economies of scale.
- The cost to customize the outer structure of the appliances was relatively low.
- The appliance industry was mature with low growth. The acquisition would offer an avenue to continue growing.

Cons

- Fragmented distribution network in Europe.
- Different consumer needs and preferences. For example, in Europe refrigerators tend to be smaller than in the U.S., have only one outside door, and have standard sizes so they can be built into the kitchen cabinet. In Japan, refrigerators tend to have several doors in order to keep different compartments at different temperatures and to isolate odors. Also, because houses are smaller in Japan, consumers desire quieter appliances.
- Whirlpool already was the dominant player in a fragmented industry.

Since Philip's had a relatively small market share in the European appliance market, one must analyze the cost structure to determine if the acquisition would offer Whirlpool a competitive advantage. With the acquisition, Whirlpool would be able to cut costs on raw materials, depreciation and maintenance, R&D, and general and administrative costs. These costs represented 53% of Whirlpool's cost structure. Compared to most other industries, this percentage of costs that could benefit from economies of scale is quite large. It would be reasonable to expect a 10% reduction in these costs, an amount that would decrease overall cost by 5.3%, doubling profits. Such potential justifies the risk of increasing the complexity of the organization. Because of the different preferences of consumers in different markets,

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a purely global strategy with standard products was not appropriate. Whirlpool would have to adapt its products to local markets, but maintain some global integration in order to realize cost benefits. This strategy is known as "mass customization." Whirlpool acquired Philips' Major Domestic Appliance Division, 47% in 1989 and the remainder in 1991. Initially, margins doubled as predicted. However, local competitors responded by better tailoring their products and cutting costs; Whirlpool's profits then began to decline. Whirlpool applied the same strategy to Asia, but GE was outperforming Whirlpool there by tailoring its products as part of its multi-domestic strategy.

Source: http://www.quickmba.com/strategy/global/

15.3.3 Support Activities

The support activities of the value chain provide inputs that allow the primary activities to take place (see Figure 15.2). The materials management (or 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 lower cost (lower C), thereby creating more value.

Similarly, the human resources 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 resources function also ensures that people are adequately trained, motivated, and compensated to perform their value creation tasks.

Information systems refer to the normally electronic systems for managing inventory, tracking sales, pricing 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.

The final support activity is the company infrastructure. By infrastructure we mean 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 can exert shape the infrastructure of a firm and through that the performance of all other value creation activities within it.

Task Identify a support activity in any organisation in your reference and analyse it.

Self Assessment

Fill in the blanks:

1. The ..... function can help create more value in a number of ways.
2. ..... refer to the normally electronic systems for managing inventory, tracking sales, pricing products, dealing with customer service inquiries, and so on.
3. The final support activity is the ..... infrastructure
4. ..... have to do with the design, creation and delivery of the product; its marketing; its support and after sales service.
5. ..... can be treated as a value chain composed of series of value creation activities including production, marketing, sales, materials management, R&D, human resources, information systems and the firms infrastructure.

Notes

6. The first major dimension of global strategy is ..... and ..... of the multinational firm's activities across countries.
7. The ..... dimension expressed by Levitt (1983) defines global strategic management as the process of offering products across countries.

15.4 Global Strategic Management Process

Modern corporations stretch around the world and are not bound by a single country. In this modern, global world it is increasingly important for managers to understand the global strategic management process. Understanding this process will help managers to choose markets, enter markets, and develop the firm in these new markets and to continually manage and develop the firm internationally.

Selecting Foreign Markets

The foundation of international strategic management is selecting the right markets to enter. There are a wide variety of factors to consider when choosing a market, including the size of the market, the strength of the market and local resources (including natural resources, capital resources and human resources). Managers must also be aware of the cultural, economic, geographic and administrative distances between countries because large distances can make doing business difficult.

Entering Markets

A good manager is highly strategic in his market entry strategy. The simplest way to enter a market is to open a wholly owned subsidiary. This can place a foreign firm at considerable disadvantage, however, because it means that the firm must quickly adapt to the local market without much local knowledge. Better options for gaining local knowledge include entering via a local acquisition or merger, either of which gives the firm access to local employees and knowledge.

Building the Firm

Once a company has entered a market, it must develop a strategic plan for growth. This involves building the local reputation and market share, but it also involves building local competencies. Local competencies are based on the locally available resources. For example, a firm's Indian branch might focus on the competence of information technology because the Indian market has a large population of IT engineers.

Continuous Management

Continually developing is an important part of the global strategic management process. Managers must continually monitor the market to determine if the market is still appropriate and if the firm is properly positioned in the market. When the market changes, the business must either adapt to the local changes or, in drastic cases, exit the market altogether.

15.5 Collaborative Strategies

Firms use four basic strategies to enter and compete in the international environment: an international strategy, a multi-domestic strategy, a global strategy, and a transnational strategy. Each of these strategies has its advantages and disadvantages. The appropriateness of each strategy varies with the extent of pressures for cost reduction and local responsiveness.

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International Strategy

Firms that pursue an international strategy try to create value by transferring valuable skills and products to foreign markets where indigenous competitors lack those skills and products. Most international skills hence created value by transferring differential product offerings developed at home to new markets overseas Accordingly, they tend to centralize product development functions at home (e.g. R&D). However they tend to establish manufacturing and marketing functions in each major country in which they do business. But while they may undertake some local customization of product offering and marketing strategy, this tends to be limited. In most international firms, the head office retains tight control over marketing and product strategy.

An international strategy makes sense if a firm has a valuable core competence that indigenous competitors in foreign markets lack and if the firm faces relatively weak pressures for local responsiveness and cost reductions (as is the case for Microsoft).

Multi-domestic Strategy

Firms pursuing a multi-domestic strategy orient themselves toward achieving maximum local responsiveness. The key distinguishing feature of multi-domestic firms is that they extensively customize both their product offering and their marketing strategy to match different national conditions. Consistent with this, they also tend to establish a complete set of value creation activities, including production, marketing and R&D, in each major national market in which they do business.

A multi-domestic strategy makes some sense when there are high pressures for local responsiveness and low pressure for cost reductions.

Global Strategy

Firms that pursue a global strategy focus on increasing profitability by reaping the cost reductions that come from experience curve effects and location economies. That is, they are pursuing a low cost strategy. The production, marketing, and R&D activities of firms pursuing a global strategy are concentrated in a few favourable locations. Global firms tend not to customize their product offering and marketing strategy to local conditions because customization raises costs (it involves shorter production and the duplications of functions). Instead, global firms prefer to market a standardized product worldwide so they can reap the maximum benefits from the economies of scale that underlie the experience curve. They may also use their cost advantage to support aggressive pricing in world markets.

Did u know? Multi domestic strategy is best suited incase of high pressure for local responsiveness and low pressure for reduction in costs.

This strategy makes most sense where there are strong pressures for cost reductions and where demands for local responsiveness are minimal e.g. semi-conductor industry.

Transnational Strategy

Christopher Bartlett and Sumantra Ghoshal have argued that in today's economic environment, competitive conditions are so intense that to survive in the global marketplace, firms must exploit experience-based cost economies and local economies, they must transfer core competence within the firm, and they must do all of this while paying attention to pressures for local responsiveness. Bartlett and Ghoshal maintain that the flow of skills and product offerings should not be all one way, from home firm to foreign subsidiary, as in the case of firms pursuing an international strategy. Rather, the flow should also be from foreign subsidiary to home country, and from foreign subsidiary-a process they refer to as global learning.

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A transnational strategy makes sense when a firm faces high pressures for cost reductions, high pressures for local responsiveness, and where there are significant opportunities for leveraging valuable skills within a multinational's global network of operations. In some ways, firms that pursue a transnational strategy are trying to simultaneously achieve cost and differential advantages. In terms of framework they are trying to simultaneously lower C and increase V.

The advantages and disadvantages of each of the four strategies are given below:

Table 15.1: Advantages and Disadvantages of each of the Four Strategies

Strategy	Advantages	Disadvantages
Global	Exploit experience curve effects Exploit location economies	Lack of local responsiveness
International	Transfer core competencies to foreign markets	Lack of local responsiveness. Inability to realize location economies Failure to exploit experience curve effects
Multi-domestic	Customize product offerings and marketing in accordance with local responsiveness	Inability to realize location economies Failure to exploit experience curve effects Failure to transfer core competencies to foreign markets
Transnational	Exploit experience curve effects Exploit location economies Customize product offerings and marketing in accordance with local responsiveness Reap benefits of global learning	Difficult to implement due to organizational problems

15.6 Ethics and Global Business

Ethics in a global management setting are needed to maintain economic balance. If a company is unethical, this can have effects beyond hurting the company. Unethical behaviour can affect consumer spending and result in other companies avoiding doing business with the offending company.

- ***Ethics:*** Ethics are philosophical beliefs that deal with right and wrong, with doing the right thing. Ethics are composed of personal beliefs and cultural norms. Being ethical involves doing what is right, regardless of what benefits might be gained. In business, having strong ethical standards leads to having individuals and businesses believe in the overall trustworthiness of the business involved. When ethics are involved globally, it can lead to increased cooperation and commerce based upon parties trusting one another.
- ***Education:*** To highlight the need for ethics in global management, business schools are incorporating ethics courses into their business curriculum. The Harvard Business School, for example, has had individual courses in ethics training since 1908, but other schools are providing ethics training to students seeking business degrees.
- ***Perception:*** Global management needs to take ethics into consideration when it comes to public perception. If a company has a bad image due to unethical behaviour, that tarnished image can hurt the company and anyone that the company might be trying to help. In 2002, Zambia was having a famine and Monsanto donated corn to the country. But because Monsanto had an image for unethically modifying grains without telling the public, the donated corn was refused.
- ***Rural Areas:*** When it comes to global management, one area in which ethical behaviour has been lacking is helping out rural areas. In India, which has issues with corruption and

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unethical business behaviour, while the metropolitan areas are developing, the rural areas have fallen by the wayside. In order to remedy this, India has undertaken a program in which ethical standards will be at the forefront of the business community. By helping out rural areas, it will eventually help out the entire country by making both rural and commercial areas modernized.

- ***Implementation:*** When a company puts ethics into part of its global management plan, it acts to improve public perception of the company and also works to have present and future business partners cast in a favourable light. Starbucks, for example, works diligently to keep its ethical standards at the forefront of public awareness, whether it is its "fair trade" coffee policy or by appointing an executive to head the Ethics and Compliance Office. The latter ensures that any business practices that Starbucks engages in on any level from globally to locally are ethical.
- ***Importance:*** The importance of ethics when looking at global management can't be underestimated. Living in a world that is interconnected means that unethical business decisions in one company might have implications that are felt world wide. This was witnessed during the Enron scandal. A single company that behaved unethically shook financial markets around the globe.

15.6.1 Global Business Ethical Issues

Large multinational companies affect a variety of stakeholders such as customers, creditors, investors, employees and the communities in which they operate. Responsibility to their stakeholders is demonstrated through strong environmental, social and governance (ESG) performance, sometimes described as corporate social responsibility. This can have positive impacts on profitability, by making the business sustainable and improving its reputation, but it can also increase costs. Cost cutting can lead to poor ESG performance.

- ***Environmental Protection:*** Companies have a range of impacts on ecosystems through mining and extraction, the use of water supplies, waste disposal and pollution. Companies often operate in developing countries where regulations are weak. As a solution to this, attempts have been made to put in place market-based transparency mechanisms to encourage companies to report on their environmental impact. The Carbon Disclosure Project has encouraged companies to report on greenhouse gas emissions as well as water use and impacts. Strong environmental performance is often essential to having a sustainable business model, especially where companies risk degrading inputs, such as fishing stocks.
- ***Corporate Social Responsibility:*** The activities of multinationals impact the communities where they operate, especially employees of the company and its suppliers. Problems can arise from an unequal distribution of power between employers and workers, especially in poor areas with high unemployment. This may result in unfair wages and poor working conditions, for example in sweatshops. Initiatives such as Fair Trade accreditation have arisen in response to these problems.
- ***Governance Issues:*** Suppliers, customers, creditors, investors and employees have an interest in a company being governed responsibly, so that it is profitable and does not go bankrupt. Scandals such as the collapse of Enron demonstrate the problems that can arise where companies are not governed responsibly.
- ***Responsible Investment:*** Responsible investment is a rapidly growing trend. Its core values are laid out in the UN Principles for Responsible Investment, and its essence is investment in companies with strong ESG performance. Investors are interested in this not only for ethical reasons, but because it can lead to increased returns through reputational and sustainability factors.

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Self Assessment

Fill in the blanks:

8. Due to favourable ……., New Zealand may have a ……. for automobile assembly operations, but high …….. would make it an uneconomical location from which to serve ……... .
9. …….. stretch around the world and are not bound by a single country.
10. The foundation of …….. is selecting the right markets to enter.
11. A good manager is highly strategic in his …….. .
12. The simplest way to enter a market is to open a …….. .
13. …….. is an important part of the global strategic management process.
14. A …….. makes some sense when there are high pressures for local responsiveness and low pressure for cost reductions.
15. Global firms tend not to …….. their product offering and marketing strategy to local conditions because customization raises costs

Case Study

The Starbucks Experience—Going Global

Most analysts who follow Starbucks are bullish on the stock, despite the current general market woes. After all, a share purchased in 1992 at the IPO is now worth more than sixteen times its original value, taking into account stock splits. As Schultz points out, a contemplative moment of relaxation over a Starbucks latte is an affordable luxury even during a recession. 'I have a strong buy recommendation on the stock', says John Glass of Deutsche Bank Alex Brown. 'This is the best long-term play in the restaurant/retail field I've ever seen.' As long as the company sticks to its core expertise, Glass is confident that the firm can continue to expand successfully. Schultz clearly tried to spread the Starbucks brand image too thin, particularly with forays into various internet companies that made the share price tumble severely in the summer of 1999. But when the brand sticks close to its identifiable product—the cold coffee drink Frappuccino, sold in a venture with Pepsi, or coffee-flavoured ice cream with Breyer's—it may succeed.

The major unanswered question is how Starbucks will fare in continental Europe over the next few years, particularly when it goes back to Italy, where Schultz had his epiphany in 1983. It is likely that Star-bucks will do well in Germany, where there are already Starbucks clones. But what about Scandinavia, which already prides itself on its fine coffee heritage and the world's highest per capita coffee consumption? And what about France, which has a long history of anti-American sentiment and which already hosts a vibrant cafe culture? Finally, of course, what about Italy, with its 121,000 existing neighbourhood espresso bars? Peter Maslen, the president of Starbucks Coffee International, is cautiously optimistic. 'We know that Europe has a long coffee tradition, so it's with humility and respect that we

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come back to Europe.' On the other hand, he says that 'so far, we've been very fortunate; we've been embraced everywhere we've gone without exception, but it still surprises us.'

That isn't quite true, however. When Starbucks opened an outlet in Beijing's Forbidden City in 2000, it provoked protests from Chinese nationalists such as Duan Fei, a middle-aged officer in the People's Liberation Army. 'This is an American product', he complained. 'It's imperialism. We should kick it out.' On the other hand, Huang Bing, a young part-time model, bubbled, 'It's fantastic. Coffee is cool now. The Forbidden City can be cool, too.'

That attitude is likely to be the key to Starbucks' success in Europe over the next few years as well. With minimal advertising, Starbucks already has phenomenal brand recognition around the world, through word of mouth, movie placements, and the like. With its saturation placement, Starbucks acts as its own advertisement, analyst John Glass points out. 'Almost anywhere in the world, even in Beijing, you can see one Starbucks outlet after another. They've raised store density to a level I've never seen before. Their secret is to put outlets in suburban markets, with a second and third in each town.'

In Europe, while older people may remain faithful to their neighbourhood cafe, it is likely that younger consumers will flood the new Starbucks. If the company is wise, it will open its first Italian franchise in Milan, which is a fast, trend-setting city. Since that is where Schultz had his first espresso, it would be a sweet full circle as well.

Dan Cox, owner of Coffee Enterprises, thinks that the fate of Starbucks in Europe depends on its cultural savvy. 'If they go in with the attitude, "We're Starbucks and know it all, we're bringing good coffee to the heathens", then I think they'll be in for a surprise.' But he points out that if Starbucks is more astute, it could do quite well, offering its 100% fine Arabic blend, since the trend in Europe has been to increase the amount of inferior Robusta used in blends. Norwegian Alf Kramer, the co-founder of the Specialty Coffee Association of Europe, is cautious in his forecast. 'Europe is a continent with a huge variety of coffee cultures, and Starbucks will have to adapt to all of them. When all that is said, however, coffee as a product is probably not that important to Starbucks. People will go to them for the fifteen minutes of relaxation.'

Ted Lingle, the executive director of the Specialty Coffee Association of America (SCAA), says that Star-bucks has a 'strong potential to do well in Europe, in part because its proven retail concept, established management team, substantial financial resources, and a good game plan'. His only caution is that 'one approach does not fit all countries. While the Starbucks Experience is their signature, that may not call for the same execution in every country or city. That could apply to the menu mix, the availability of chairs or just walk-away tables, and hours of operation.'

At the moment, the Starbucks rollout appears to be advancing like a well-oiled machine. It may vary its food offerings somewhat to fit local tastes, but Peter Maslen says that it has no plans to alter its coffee. People can choose milk-based drinks, drip coffee or espresso, light or dark roasts. 'We want to elicit the same emotional response all over the world', he emphasizes. Before going into a country, Starbucks conducts extensive focus groups and quantitative research.

The company also seeks a strong local business partner, which shares its values and aggressive growth strategy. 'We have no debt and we're spinning a lot of cash, so we could go on our own', he says. But Starbucks wants to rely to some extent on a business partner's local knowledge and enterprise, and this strategy also allows the company to expand more rapidly with the same resources.

Despite occasional protests by activists, Starbucks has managed to maintain a squeaky-clean image, working with Conservation International to promote shade-grown, ecologically friendly coffee. It sells Fair Trade certified coffee and encourages local employees to

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volunteer in orphanages and other worthy causes. In the midst of the disastrously low prices coffee growers are getting for their green beans, Star-bucks gave a one-time shot in the arm of $1 million to the Calvert Social Investment Foundations to help coffee farmers. At the same time, the company announced that it would expand its fair trade programme, promising to buy at least a million pounds over the next year and a half.

And the bright-eyed coffee evangelists who serve up Starbucks blends throughout the world are all trained in the Starbucks Experience that some have likened to a cult. 'Starbucks is a brand built on passion,' Maslen says, 'and you can easily feel the passion of our partners in any of our international stores.' To instil this attitude in its first Swiss employees, Starbucks flies its new foreign managers to Seattle for thirteen weeks of rigorous education and indoctrination.

Will Starbucks approach a saturation point in places like the United States and, eventually, elsewhere in the world? Will it face increasingly stiff competition as imitators spring up to feed on its success? Amazingly, there is no real Pepsi to Starbucks' Coke, anywhere in the world. Tully's and Seattle's Best Coffee (SBC, now owned by AFC Inc.) also have international profiles, but they are so far behind Starbucks that they pose no real threat.

And saturation? That's not likely to be an issue for the next few years. Look at all those coffee bars in Italy. What if Starbucks could convince the Chinese to drink coffee like Italians? Also recall lessons from history: in London, back in 1700, there were 2,000 coffeehouses. Even in the US and Canada, there still appears to be room for growth. In the province of Quebec, for instance, Starbucks teamed up in 2001 with a Quebec pizza franchiser to open some seventy-five retail outlets. And in [the] state of Vermont, Starbucks has recently opened one lonely outlet in Burlington, the hip college town. There is obviously room for growth. They don't seem to be feeling the success wind down; Starbucks has just opened its third US roasting plant in Nevada, a 300,000-square-foot facility scheduled to begin operations in 2003.

And what happens if an emergency arose and leader Howard Schultz had to leave the company tomorrow? Analyst Glass isn't worried. 'Schultz is important, one of the great entrepreneurs of our time, but he has already taken on more of an ambassador role with a concentration on international development. He leaves the day-to-day operations to CEO Orin Smith and CFO Michael Casey. Starbucks has a wonderful, deep management team. It is not dependent on one person.' On the other hand, he notes that Schultz 'embodies the passion, the human side' of the company, and as a symbolic leader of the loyal troops he is unparalleled.

Questions

1. Discuss the forces for and against the globalization of the coffee shop industry.
2. Discuss the advantages and drawbacks of Starbucks' global strategy.
3. If you were Starbucks' global manager, what would you do differently? And what would you stop doing?

Source: Mark Pendergrast (Feb. and Mar. 2002), 'The Starbuck experience: going global, tea and coffee', www.teaand-coffee.net/0202/coffee2.htm, 176(2).

15.7 Summary

This unit attempts to give an overview of the functions in as simple manner as possible.

- A firm's strategy can be defined as the actions that mangers take to attain the goals of the firm. For most firms, the pre-eminent goal is to maximize long-term profitability. Maximizing profitability requires firms to focus on value creation.

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- Due to national differences, 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. This strategy is referred to as focusing on the attainment of local economies.
- By rapidly building sales value for a standardized product, international expansion can assist a firm in moving down the experience curve.
- International expansion may enable affirm to earn greater returns by transferring the skills and product offerings derived from its core competencies to markets where indigenous competitors lack those skills and product offerings.
- 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.
- The best strategy for a firm to pursue often depends on a consideration of the pressure for cost reductions and for local responsiveness.
- Pressures for cost reductions are greatest in industries producing commodity-type products where price is the main competitive weapon.
- Pressures for local responsiveness arise from differences in consumer tastes and preferences, national infrastructure and traditional practices, distribution-channels and from host-government demands.
- Firms pursuing an international strategy transfer the skills and product derived from distinctive competencies to foreign markets, while undertaking some limited local customization.
- Firms pursuing an multi-domestic strategy customize their product offering, market strategy, and business strategy to national conditions.
- Firms pursuing a global strategy focus on reaping the cost reductions that come from experience curve effects and location economies.
- 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 a may not be easy.

15.8 Keywords

Economies of Scale: Cost advantages associated with large scale production.

First-mover Advantages: Advantages accruing to the first to enter a market.

Global Strategy: Strategy focusing on increasing profitability by reaping cost reductions from experience curve and location economies.

International Strategy: Trying to create value by transferring core competencies to foreign markets where indigenous competitors lack those competencies.

Multi-domestic Strategy: Emphasizing the need to be responsive to the unique conditions prevailing in different national markets.

Trans-national Strategy: Plan to exploit experience-based cost and local economies, transfer core competencies with the firm, and pay attention to local responsiveness.

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15.9 Review Questions

1. "The value systems and norms of a country can affect the costs of doing business in that country" Discuss.
2. What is not ethical in one country might be common in another? Despite this, the "when in Rome" approach to business ethics is dangerous. Do you agree?
3. In a world of zero transportation costs, no trade barriers and non-trivial differences between nations with regard to factor conditions, firms must expand internationally if they are to survive. Discuss.
4. Are the following global industries or multi-domestic industries: bulk chemicals, pharmaceuticals, branded food products, movie-making, television manufacture, personal computers, airlines travel?
5. Discuss how the need for control over foreign operations varies with the strategy and core competencies of a firm. What are the implications of this for the choice of entry mode?
6. Explain the relation between global strategic management and business ethics.
7. What are the peculiarities of global strategic management?
8. How can firm act as a value chain?
9. Differentiate between primary activities and support activities.
10. Write a short note on the various collaborative strategies.

Answers: Self Assessment

1. Human resources
2. Information systems
3. Company
4. Primary activities
5. Firm
6. Coordination and configuration
7. Standardization
8. Factor endowments, comparative advantage, transportation costs, and global markets
9. Modern corporations
10. International strategic management
11. Market entry strategy
12. Wholly owned subsidiary
13. Continually developing
14. Multi-domestic strategy
15. Customize

15.10 Further Readings

Books

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